THE INDIAN INVESTOR

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By

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TO
THE MEMORY
OF
MY FATHER

CONTENTS.

Introduction

The lack of adequate knowledge by the Indian public on the subject of investments and a desire to save repetition of the basic principles every time advice is sought, have prompted me to write this book. In it I have endeavoured to take the reader by the hand and show him that the business of investment is not after all so risky as he believes it to be, although I do not think the average investor is far wrong in supposing that investments involve great risks. This is chiefly because "investment" is confused with "speculation". There is no definite boundary line between the meanings of these two words, and it is because of this that the investing public fail to discriminate between the two.

This failure, together with their very limited knowledge of the subject and misguidance, has very often resulted in loss, which has instilled into their hearts a fear which no one but they themselves can eradicate. To do so they must know the principles of scientific investment, and I have attempted to give these to the reader, step by step, in as simple a language as the case will permit. I have not put forward particular theories, either my own or anybody else's, and

then gone on to expound them. Guided by my limited experience, I have shown a practical way, supported by facts and figures.

I do not claim to be an investment expert. The subject interests me deeply and it is just a desire to render what assistance I can to the Indian investing public that has prompted me to record the results of my study of the subject. My extreme anxiety to take a short road to the mastery of the subject has led me to take lessons from my blunders and mistakes, and also from those of others, of which I have always made a deep and critical study.

In the course of my short experience in the line I have helped many friends and others to invest their funds scientifically. I have on many occasions visited Calcutta, Madras, Delhi, Lahore and other places solely for the purpose of discussing investment matters personally with my friends and other investors, and these opportunities have given me a very good chance of studying the problems confronting investors throughout our vast country. It may sound strange when I say that there is a perceptible difference between the Bombay investor and his upcountry counterpart, not excluding that of Calcutta. The investor of Bombay does not readily respond to the recommendation made to him owing, perhaps, to nervousness on account

of his past losses, and even if he makes up his mind and invests, being more sensitive than investors of other places, he sometimes liquidates when there is a panic due to the market being swayed by speculators—I should call them "master speculators", for there are few on earth so clever as the Bombay fellows—thereby, suffering a loss. The upcountry investor views such a situation differently. A falling market does not always bother him and if he has enough spare money when a collapse occurs, he is not slow to take advantage of the situation, thereby profiting where his Bombay friend makes a loss.

If, therefore, this book, based on my practical experience, has even made the average investor realise that investment is not so risky as he believed it to be and if it has been instrumental in kindling the heart of the nervous investor, then it will not have been written in vain.

I am fully conscious of the fact that, while attempting to dissuade the innocent public with a limited knowledge and means from being lured by the tales of only a very few who have made fortunes by speculation, I have trained my guns against the gamblers. I am not sorry for it. With the excitement of such tales we usually ignore the other side which exists to everything. I deprecate speculation, not because I have burnt

my fingers—a good lesson which I had fully anticipated—but because I am fully convinced that scientific investment affords a far better chance of making money than even systematic speculation. Needless to say, however, that careless investment is no better than aimless speculation.

In order to show cumulative results of the workings of the various companies comprising one industry, I have compiled important information covering the last 15 years and set it forth in the form of charts representing each industry in India, with the exception of a few, most of which, being new, defy accurate compilation. These charts are not given to help the reader to forecast which way the various industries are heading. None but Americans believe in charts which are supposed or drawn to forecast major or minor movements. I take such charts as the wheel tracks of an aimless cart in a desert which only indicate which way the cart has gone and where it is but never which side it will turn. But the charts that I have presented to the reader are not for any purpose other than to retrospect each industry at a glance, and without figures and words which would perhaps cover a few volumes.

I should have liked to entitle this book "Scientific Investments" as it deals with nothing

else but a scientific way to successful investment, but I felt such a title would not have indicated sufficiently clearly the purpose for which it has been written. It has been written not for specialists but specially for Indian investors whose circumstances differ fundamentally from investors abroad. It aims at discouraging aimless and reckless speculation and showing the methods of scientific investment, calculated to help the flow of Indian capital along the right channels thereby promoting industrial prosperity and raising our standard of living. Without stimulating investments we cannot kindle entrepreneurs and without them we cannot accelerate our prosperity. Therefore, the logical conclusion is that investment plays a very important part in human life, and I hope that this work will primarily help the Indian investing public to give their capital a safe and profitable outlet, which will in turn instil confidence into idle capital which is reputed to be shy.

This book embraces two distinct features: (1) it prepares an inexperienced investor of even ordinary intelligence to study the principles underlying scientific investment, and after showing how these can be applied, proceeds to compile an investment portfolio suitable for his own requirements and to show how to manage it, (2) it endeavours to convince experienced but unmethodical investors and speculators alike

that the system of scientific investment—a system entirely devoid of throbbing moments, frowns and sleepless nights—universally acknowledged to be the best, when worked over a series of years, offers far greater advantages than any other method.

Chapters III, IV and V will be found to deal with Balance Sheets. Despite the fact that there are several books written on balance sheets, dealing comprehensively with the subject, I have deemed it expedient to touch upon the vital points necessary to scrutinise a balance sheet, thus giving the reader in a few pages a summary of the important contents of these books. Readers, particularly those who have no knowledge of the subject, are urged to go through these pages carefully, reading them more than once if necessary, until the contents are mastered.

From a casual reading it may seem that it is almost impossible to study and follow the principles advocated in this book. As I have already said, there is nothing in it that is based on mere theories. Everything there is in it is practicable. To risk carelessly our savings—which literally means accumulated hard labour—just because we do not want to go to the trouble of learning, amounts to nothing short of allowing ourselves to drown because we refuse to attempt to master the art of swimming.

In conclusion, I wish to express my indebtedness to my friends whose forbearance has helped me to make a deep study of their successes and failures. My thanks are due to Professor P. Andrade for having so very kindly undertaken the task of correcting my diction. My thanks are also due to other friends whose criticism has guided me in completing this work, and to Messrs. Place, Siddons & Gough, Calcutta and Kothari & Sons, Madras, particularly the former, whose annual reference books have helped me immensely in drawing charts and making occasional references. To the good nature of my brother, which has kept me free from domestic cares, I can pay no adequate tribute.

C. F. C. DE SOUSA.

Coover Villa,
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December, 1941.

POSTSCRIPT.

A slight and unavoidable delay occurred in sending this work to the press, within which time Japan and America entered the war, with the result that all shares and securities are marked down at present. As the principles advocated in this book are not based on any particular prices, it was not felt necessary to alter the prices quoted in examples. Only a few words about the later phase of the war have been inserted on page 15 with a view to emphasising the four-fold ruin that speculation can bring.

C. F. C. DE S.

February, 1942.

CHAPTER I

Scientific Investment.

The growth of civilization has brought in its train such new devices as exchange control, tariff barriers, commodity restrictions, quota systems, protection and other intricacies, increasing the difficulties of the Indian investor who has little source for reliable and authoritative information on investments. It is unfortunate that unlike Britain and America we have no sufficiently large and reliable organizations conducting business as investment consultants where unskilled and innocent investors can look for guidance, or where others can check their own ideas and conclusions.

Books generally help in such an eventuality. There are hundreds of them written by foreign authors but all treat subjects from the point of view of their own requirements and, as far as the author is aware, there is not a single copy existing to-day which substantially helps the Indian investor, because our conditions and circumstances differ considerably from those of the abovementioned two countries. It is, therefore, hoped that this work will throw light on the vital problems confronting the Indian investor.

Only a few of us have the fortune of having the investment portfolios prepared by investment experts and on the strength of that we generally sit tight over our holdings confidently looking forward for dividends to roll in with clock-work regularity and for capital to appreciate in due course. If the list does not fulfil the purpose for which it was intended, or does not function properly, then we are not slow to blame our luck, if not the investment expert, without making any attempt to see where the fault lies. To-day, more than ever, no investment list, however sound and well constructed, can be indefinitely kept without overhauling if maximum benefit is to be derived from it. Once the list or the investment portfolio is constructed we heave a sigh of relief as an indication that our investment problem is over. In fact, however, as soon as the investment portfolio is prepared, our work merely begins. When a portfolio is compiled in certain circumstances it must logically be revised when these circumstances change. A successful investment portfolio is, therefore, never complete. It is like any other business, but in an invisible form, always requiring not the routine work but specialized management which one alone can give to one's own investments.

As conditions are, all of us cannot have access to authoritative and reliable information.

This is one of the reasons why we must have some knowledge of investments so that our knowledge, the knowledge of brokers and of friends may be combined to give primarily a safe home to our capital, and then to supplement our main income by the investment income and to appreciate capital.

Another reason why we must have some knowledge of this subject is that individual circumstances differ. We know that one man's meat is another man's poison. And this holds true in the case of investments also. For example, let us assume that A and B each have Rs.10,000 to invest. Both are in service holding decent positions, are of equal age, have another Rs.5,000 apiece invested in sound securities, have an equal number of children of the same age; all other factors affecting their financial position are almost identical and temperaments same, but the only slight difference is that A has two insurance policies of Rs.5,000 each maturing within 10 years at intervals of 5 years, whereas, B has one of Rs.10,000 maturing after 15 years. If this difference is not taken into consideration then naturally the planning for both should be the same, say, over half the capital in ordinary shares. But if the difference in circumstances is taken into account, can it be said that the scheme drawn for investment is suitable for both? Definitely no, because A,

knowing that he has to get Rs.10,000 from the Insurance company within 10 years, will not worry much over the behaviour of his investments, relying upon the Rs.10,000 if need be, for the education of his children and for their well-being, whereas, B will have to plan in a different way so that he may be able to liquidate a part of his holdings at regular intervals to meet the expenses of his children's higher education and possibly dowry, if he has a marriageable daughter, any time without any sacrifice of capital, whatever the condition of the market may be. But if over half his capital is in ordinary shares as in the case of A and he is forced by circumstances to liquidate all or a portion of his capital on a depressed market, we can well imagine what B's position would be.

To carry this argument a little further, let us suppose that a young man has managed to save from his earnings Rs.1,000 in the course of about two years. He will be justified in taking a risk by investing this amount in recovery or any speculative shares in the hope of a substantial reward. But will a man, approaching the end of his service or a retired person with the only saving of Rs.10,000, be justified in risking one-tenth of his capital in this way? Certainly not. It would be advisable to have his entire saving of Rs.10,000 placed in sound scrips rather than place nine-tenths in gilt-edged securities and risk

one-tenth in the manner a young man may like to invest.

These are two imaginary cases. Both go to prove that investment requirements differ according to circumstances. Such instances are met with by an investment consultant in hundreds, in varying degrees, which, in fact, are distinct from one another. If, therefore, the social and economic life of a person is not taken into consideration while suggesting investments or compiling an investment portfolio, serious consequences may result.

But can full details of our social and economic life be disclosed to the investment consultant or to a broker? Something tells us that we simply cannot. This is one more reason why it is necessary for us to have sufficient knowledge to handle our own investment affairs.

It is curious why the matter of investments is so very lightly treated by most of us. We often approach the question of investments indifferently or in the manner we approach a shopkeeper and buy simply because others say it is good. To illustrate this statement the first instance that immediately comes to mind is that of purchasing an immovable property. When we think of buying one how much do we not worry over it? We discuss the matter with half a dozen friends; seek advice of a couple

more; approach a few brokers and friends and ask them to look out for a financially embarrassed land-lord or for one who, for some reason or other, is in a hurry to sell his possession, so that a good bargain may be struck; run here and there; look out for several houses for sale; inspect them with friends, critically examine documents of those we are most interested in with the help of lawyers and architects; calculate the yield and what not. Even before buying a car how much do we not worry and trouble ourselves? Nothing of this sort is done while we embark upon investments involving thousands of rupees, or perhaps all our savings, inherited money or life's fortune. All we do, generally, is to approach a friend who has some knowledge of stock markets. He recommends a few shares in good faith because others say they are good. Or we approach a broker, if we know one, and take his tip which is only the echo of the talk of the day but which frequently turns out to be a tap to manipulators.

The first step before approaching investment should be to define clearly our object, that is, to survey thoroughly our future requirements of the funds we intend investing and consider whether we want them to produce a secure income or capital appreciation, or both. Every investor, since individual requirements differ, has to do his own planning and not just follow

blindly the recommendations made to him. These might be for investment in strong companies having future prospects but still all the funds in one company or in several of the same industry will not be beneficial in the long run. Such companies prosper only as long as the trade in the goods they manufacture is good. When there is a setback, all holdings automatically suffer. It is, therefore, not only desirable but also necessary to distribute the risk. How this can be done will form the subject of a separate chapter.

If we only want to learn, there are many sources from where we can take lessons. The main principles advocated in this book are those adopted by such experienced and expert investors as the Investment Trust and Insurance companies. Throughout their long experience they have found out what is best and accordingly they manage their business. We can do nothing better than take their example. Of course, with a handful of money we cannot follow the investment method of such companies, which have plentiful resources, but we can to a certain extent follow them and ward off the greater risks that beset the path of the indiscriminate and unmethodical investor.

The unmethodical investor is nothing less than a common speculator. He fares well only when the trend of the market is one-sided;

and as long as he is on the winning side he does not think of the other side but as a matter of fact, ignores it altogether. The real test of investments comes when the markets are two-sided and it is here that the unmethodical investor stands as much chance of losing as the unfortunate speculator.

After reading thus far, you will perhaps want to know why we should bother ourselves to acquire a knowledge of this subject when we have brokers always ready and willing to recommend and transact any business that we might be interested in. It must be made clear from the outset that brokers are not investment consultants. Their business is to act as intermediaries between the jobber and the public by only buying and selling what comes on the market because we are not allowed to do business directly with the jobber. You will, therefore, see that a broker is not always a specialist. Most of them do not possess knowledge of scientific investment nor do they bother to know what is going on outside their own market. It must not be thought that these lines are written with a prejudice against brokers. Far from it. Some brokers not only have excellent knowledge of the companies whose shares are quoted in their market but are also well informed about the internal affairs of some of the companies due to their association with the directors.

But complete knowledge of some scrips in one market alone does not materially help an investor in the preparation of his investment portfolio. An investment scheme, in order to spread risk, may require inclusion of shares of a certain industry that are generally not quoted in the local market, without which the scheme will not make a good showing. There is one more important point in this. For example, if a person invests all his money in Bombay scrips, say, in a steady market, all his holdings become liable to be affected at one and the same time when the market is influenced by speculative rumours without any regard to the intrinsic value of the shares and if an investor is forced by circumstances to realize a part of his holdings on a depressed market, it is almost certain that he will have to forego a portion of his capital in howsoever sound shares it may have been placed.

There are some brokers, however, who equip themselves with sufficient knowledge to render substantial assistance to the investing public and a few even maintain departments to do investment service, for this helps them to attract more clients and so increase their business. But on the whole, it will be admitted, scientific and reliable advice is scarce.

We have said enough to establish the fact that it is imperative that each investor or would-

be investor should know fairly well the principles of scientific investment which when applied critically to his own suggestions or to those made by others would benefit him greatly apart from preventing investment in what is ill-suited to him. The principles will, in addition, help him to manage his own investment affairs in a proper and methodical way without having to place himself at the hands of his consultant or broker for whom it is impossible to assume entire responsibility, keep a constant watch over all their clients' holdings and overhaul them in the manner they might wish.

You will, at this stage, be anxious to know what the principles of scientific investment are and how they can be mastered. This whole book can be taken as an answer to this question. A man equipped with ordinary knowledge requires patience more than time, and a little desire.

CHAPTER II

Speculation

It is not fitting in a book like this to discuss speculation but since there is no boundary line between investment and genuine speculation, we cannot know where one ends and the other begins. Two persons buying the same kind of share may have two different motives in that one may buy with the intention of selling it in the near future when he anticipates the market to improve and the other, satisfying himself that the concern has done well in the immediate past and continues to earn satisfactorily with better future prospects, may buy outright for capital appreciation or for good yield.

There are some investors who without caring for the yield, invest in such shares—not necessarily speculative—as have the tendency to fluctuate at short intervals and within a sort of fixed limits, with a view to snatching profit at every small rise and reinvest when the market is again in a depressed condition. They make a thorough study of the few companies they are interested in and invest the funds allocated for this purpose only in these companies and no other. There are others too, mostly upcountry investors who speculate by buying highly

speculative shares (such as Tata Deferreds, Tata Ordinaries, Bombay Dyeings, etc., of the Bombay Stock Exchange) on a depressed market with the intention to sell them at every rise or to take delivery of the shares should they fall before the time fixed by the Stock Exchange for settlement of accounts, popularly known as the "Settlement Day." They then patiently wait for a rise which generally occurs a day sooner or later. In this way some of them successfully conduct their investment business. A systematic and methodical semi-speculation is much better than reckless and aimless speculation which is one of the objects of this book to discourage.

Before discouraging speculation, we must know what it is and we, therefore, have to trespass on the grounds of speculation to a necessary extent, though, in a book of this nature one sentence, *viz.*, "Speculation is a game of chance" would have been enough, for it opens and closes one complete chapter.

There are three types of manipulators on the Indian markets, Bears, Bulls and Fools. Bears are those who in expectation of a fall in price sell a share before purchasing it, and when the price ultimately drops, buy what they have sold (technically called "covers"), thereby profiting by the difference. This procedure is

technically known as "short" selling" and "covering." Bulls do just the reverse. They buy first when the market is down and keep on buying until prices rise to a sufficiently high level and then liquidate their holdings, pocketing the difference. While Fools are those that speculate aimlessly, unconsciously and unmethodically. Although they may be speculating for a long time they have no principle nor judgment, and what is worse, many of them have limited resources which often fall below the risk they take on the speculative market. This is the only reason which frequently puts them in tight corners. They are simply swayed by rumours spread by bulls or bears, and often get caught at the extreme prices. They form the major portion of the speculative market and provide good fishing ground to the speculators that control the market.

There is another and most dangerous type of speculators. They are the Gamblers. They generally have ample means and often control speculative markets particularly that of Bombay. They combine their knowledge, experience, influence and other resources to squeeze the innocent public who enter the share bazaar in the hope of making a little money. No doubt, these gamblers have made fortunes overnight, lost fortunes overnight and sometimes knocked the bottom off their life. It is really saddening that

we should have gamblers to guide the destiny of our markets and thus ruin the innocent public, who, like every human being, have greed for money.

It is needless to emphasize the fact that in order to speculate successfully, one must primarily have more money than specialized knowledge, for it often happens that a speculator with limited means is unable to endure the strains of the market and hence cracks before the market recovers. This is how such speculators part with their savings and wreck their homes.

Instances are not wanting where many have succumbed to the vice of speculation. We know of hundreds of cases where innocent persons, including retired persons and pensioners, lured by high hopes of making fortunes, have entered the Stock Exchange and gradually drained their money, perhaps life's savings ultimately, with a desperate attempt to at least recover what they had lost. Some speculators who do not keep account of their entire transactions may hesitate a little to admit this but most of the others will readily agree that that is a fact. Why then keep hanging round the market with inadequate resources when the same can be utilized in real investments, thereby increasing income and capital, and indirectly helping the industry and well-being of the nation as a whole?

Even the other day when Japan declared war against America, Britain and their allies, markets dropped heavily resulting in the loss within only two days of what speculators had made in the past seven months due to the market being one-sided. And now they are hit so very hard that they have considerable difficulty in settling accounts. Staunch supporters of speculation will ask : " Are not investors hit too ? " The answer is : " Yes, but not to the same extent." Not even, perhaps, half as much. And no one will deny the fact that reckless speculation, in sympathy with which prices of good and bad shares alike were soaring high, was mostly responsible for what culminated into such a severe loss to genuine investors.

CHAPTER III

The Balance Sheet

This important subject has been given a place in this book only for the purpose of helping the investor, in a practical way, to scrutinize a balance sheet of any company and find out without the help of others whether or not the company in which he has investments or contemplates investing, is financially sound. It must be understood that this subject, the thorough treatment of which requires the space of more than a volume, cannot be fully discussed here, nor can all the salient features. But an endeavour has been made to give the uninitiated in a condensed form and in non-technical language, avoiding accounting intricacies as far as possible, every assistance in learning to distinguish a bad concern from a good one. It is also contemplated here to give a few hints on how to read a balance sheet and this will, it is hoped, help to solve the problems confronting each investor and thus lighten his task of criticism, to which he generally has no incentive.

Those who have no knowledge whatever of balance sheets may skip this chapter until they come to the end of this book and then go through it with all attention, preferably reading

it all over again, for a first reading may not reveal to the untutored mind all that the chapter is meant to convey.

To the critic, the balance sheet is a mine of valuable information, but it is invariably looked upon by the uninitiated as a statement of bewildering figures and, therefore, almost always finds the waste paper basket as soon as it enters their house. But, in fact, to a person of even ordinary knowledge, two or three concentrated readings should not present as much difficulty as the first reading.

What is a Balance Sheet? In simple words, it is, as the word "balance" suggests, the statement of balances of all the accounts standing in the company's account books at a given date, and which shows the assets and liabilities of a company. These balances when grouped together and arranged in a Balance Sheet, make no doubt a complicated reading for the following reasons: (1) there are so many varieties of accounts and they have so many different purposes that it is impossible to compile balance sheets on a strictly uniform basis; (2) they are sometimes made obscure to withhold certain information from the shareholders and the public; (3) some prudent companies have hidden or secret reserves which are created by writing off excess amounts for depreciation,—a proce

dure that makes the company's financial position to appear less sound than it really is. Nevertheless, a trained mind can dig out sufficient facts and figures to satisfy one's purpose in view.

A balance sheet is divided into two parts:

(*a*) Assets, and

(*b*) Liabilities.

The former are arranged on the right hand side of the balance sheet whilst the latter are arranged on the left.

Assets can be broadly divided into four parts, *viz.*, (*a*) Fixed Assets, (*b*) Circulating Assets, (*c*) Liquid Assets, and (*d*) Intangible Assets.

Let us first consider what the "Assets" side of the balance sheet discloses.

(*a*) Fixed Assets: The fixed assets—generally called "Fixed Capital Expenditure," "Block" or "Block Expenditure"—constitute the main productive structure of the company, such as land, buildings, plant, machinery, etc. The fixed assets sometimes include "Wasting Assets," such as those of a mine. When the mine is worked out, these assets, whether buildings, machinery or plant, fetch little value.

To ascertain the real value of fixed assets we must see whether proper depreciation is written off the value of the asset. If in the balance sheet under the caption of "Fixed Capital

Expenditure," we do not find any reference to "Depreciation" we should see on the "Liabilities" side of the balance sheet whether there is any item under the caption of "Depreciation Fund" or "Sinking Fund" or "Depreciation Reserve." We should also read the Auditors' report on the balance sheet because according to the Law an Auditor is bound to report to the shareholders if in his opinion the provision for depreciation is inadequate. It must be remembered that the depreciation written off must *not* be inadequate. If the depreciation is inadequate it is advisable to treat it at a discount commensurate with the age of the asset and its probable life.

(*b*) Circulating Assets: These are, as the term suggests, unmanufactured, unsold and unrealized assets of the company. In other words, they represent the balances of production, etc., such as stock-in-hand, stock-in-trade, book debts, work-in-progress, etc.

Stock-in-Trade: A company in course of business must have some stocks at the time of drawing a balance sheet which it had no time to sell, so also it is probable that some of it is in transit which it has not been possible for the concern to record in its books.

Too big a stock in hand is not a healthy sign, for it indicates that the goods are not as quickly

sold as they are produced. To find out whether the stock is high or low, the figure of the total sales for the year, placed on the credit (right hand) side of the Profit & Loss Account, is the best guide.

The fixed assets, the stores, stock and the work-in-progress are like a safety valve and should receive much attention from the critic. That is, they are very flexible and frequently advantage is taken of them by those responsible for a company's affairs. Those companies that wish to create secret reserves adopt the policy of writing off the value of fixed assets very much more than necessary whilst showing the stock, stores and work-in-progress at or below cost. " Below cost " has no meaning to the critic unless he has detailed information of the working of the concern. Conversely, a company whose running is not smooth or is in financial difficulties often tries to provide as much less as it conveniently can for depreciation of its assets and even skip this off altogether at times. Stores, stock and work-in-progress are also sometimes inflated by showing them at cost if their value has fallen since purchase or at market price if their value has risen since their manufacture or purchase.

Book Debts : These represent outstandings recoverable from customers or constituents.

Goods sold on credit or advances made by Bankers and financiers to their customers take time for recovery and until such recoveries are made the debts (or outstandings) constitute an asset of a concern. Such debts are sometimes classified as "trade debts" or "sundry debtors."

When goods are sold on credit the inevitable consequence is that a fraction of the sale falls into the hands of doubtful or financially weak traders and hence bad or doubtful debts result. Debts are sometimes "secured," which means that the debtor has given some sort of security, either by pledge, mortgage or otherwise, to the concern so that the company is safeguarded against the debt becoming bad.

This asset should be closely surveyed. Under the Law, the directors are bound to distinguish this asset between (*a*) debts considered good, (*b*) debts considered bad or doubtful, (*c*) debts unsecured, (*d*) debts secured and (*e*) debts due by directors. For any negligence in distinguishing the assets as between the aforesaid heads, an auditor is responsible together with the directors. We should always scan through the "Liabilities" side of the balance sheet to see whether there is any item like "Reserve for bad or doubtful debts." If there is one, that item represents a reserve for such contingency

created out of the company's profits. If there is no reserve one would err on the safer side if he treated this asset at about 5 per cent. discount.

It will be noted that at times some companies advance money to their subsidiary companies. When such an advance is disclosed in a balance sheet the interested investor should not fail to investigate the balance sheet of the subsidiary company so as to ascertain whether such advances are good or bad or partly doubtful. It may be that a loan was given to help increase the business of the subsidiary company or to help it out of difficulties. The balance sheets of subsidiary companies are by law required to be attached to the balance sheets of parent companies.

Work-in-Progress : This is self-explanatory. The figure arrived at is the cost price of unfinished work or goods in the process of manufacture on the date the balance sheet was compiled.

(c) Liquid Assets : These are easily ascertainable from the balance sheet as they constitute cash in hand, cash with bankers, investments, etc. If there are investments shown on the " assets " side of the balance sheet we should scrutinize the details carefully. If there are gilt-edged securities they are generally shown at cost, unless there is a permanent setback in the investment market, in which event the value is written

down. If the investments comprise of shares in other companies, then naturally, the value thereof could not be properly ascertained unless the balance sheets of such other companies are scrutinized. However, the value of the shares could be compared with the Stock Market quotations on the date of the balance sheet, and if a marked difference is observed in the value as shown in the balance sheet it should be inferred that the value of the investments has not been properly depreciated. Cases sometimes occur when the investments appreciate in value instead of depreciating. At such a time, according to a very famous judgment of an English Court, such appreciation could not be treated as the profit of the company unless such a company has revalued all its assets and the appreciation is utilised first towards depreciation (if any) of other assets.

(*d*) Intangible Assets: Intangible assets are those that have no cash value during the company's existence. Goodwill, Patent Rights, Trade Marks, Preliminary Expenditure, Development and such like expenditure, come under this category. They are dead assets except at times Goodwill, Patents and Trade Marks, and must be eliminated from the balance sheet as quickly as possible.

We shall now come to the other side of the balance sheet, *viz.*, the " Liabilities " side. These

can be divided into two parts, *viz.*, (*a*) Liability to the shareholders and (*b*) Liability to the public.

(*a*) Liability to the Shareholders: The liability to the shareholders constitutes share capital (not Loans or Debentures), Reserve and other Funds representing undistributed profits, and balance of profit standing in the Profit & Loss Account. The capital shown in the balance sheet contains many statutory particulars but it is only the paid-up capital with which we are concerned. In a balance sheet we generally find the "Authorized" or "Nominal Capital" which a company is entitled to offer to the public for subscription, "Issued Capital" which represents the capital so offered, "Subscribed Capital" which represents the amount of capital taken up by the public in response to the offer made to it, and finally "Paid-up Capital" which represents the instalments paid on each share by the public. A share may be fully paid-up or partly paid-up. When a share is fully paid-up there remains no more liability of a shareholder to pay any further amount in respect thereof, but when it is partly paid-up a shareholder is always responsible to pay the unpaid amount thereon either to the directors (in the event of a company requiring further capital) or to the liquidators (in the event of the company's assets being insufficient to pay its liabilities). Once the shares acquired by a

shareholder are fully paid for, he is not entitled to get his money back from the company until the company is wound up and until in the winding up thereof there remains a surplus of asset after discharging all the liabilities. Only in the event of the capital being in excess of the company's wants then by a drastic reconstruction of same it is possible to return to its shareholders that portion which is deemed to be in excess. But, a shareholder may sell the shares to another person through a Broker as is generally done in Stock Exchanges or directly from one person to another in cases where the shares for sale are of private limited companies, or are of public companies the shares of which are not quoted on the Stock Exchange.

Reserve and other Funds: The kernel of the "liabilities" side lies here. The funds—sometimes also called Accounts—represent undistributed profits earmarked for different purposes and hence arranged under several heads. These often confuse the reader. There are many of them, such as General Reserve Fund denoting no specific purpose; Depreciation Reserve denoting amounts set apart to meet wear and tear of several assets; Sinking Fund representing reserve for waste of assets or for redemption of a liability; Dividend Equalization Fund representing reserve to enable a company

to equalise dividends in lean years; Miscellaneous Fund, etc.

Reserves are created by prudent management out of company's profits as a hedge against exigencies. Reserve fund for example is created as a set-off against lean years but it is also often used for other purposes than this. A company, for example, foreseeing expansion of business may wish to provide the working plant with extra machinery. Utilization of the reserve fund for such a purpose would immensely help the company's finances and working. The company would then earn considerably more. A prominent Bombay Mill had once purchased two more mills out of its Reserves. "Ploughing-in" is the term sometimes applied when the accumulated profits are utilized in this way or are kept in business. When this is done a change takes place in the accounts of the company. For example, a company with a reserve fund of Rs. 10,00,000 and fixed assets amounting to Rs. 10,00,000 requiring the help of the reserve fund to the tune of Rs. 5,00,000 for the purpose of expansion will have to utilise Rs. 5,00,000 from the reserve fund and convert the liquid assets created out of such reserves into fixed assets thus diminishing the liquid asset by Rs. 5,00,000 and increasing the fixed assets to Rs. 15,00,000.

Let it be illustrated in figures.

Balance Sheet when the Reserve is lying idle:

	Rs.		Rs.
Capital	10,00,000	Fixed Assets	10,00,000
Reserves	10,00,000	Stock, Book Debts, etc.	10,00,000
Liabilities	8,00,000		
Profit Balance ..	2,00,000	Investments (out of Reserve Fund) ..	10,00,000
	30,00,000		30,00,000

Balance Sheet when the Reserve is utilized:

	Rs.		Rs.
Capital	10,00,000	Fixed Assets ..	15,00,000
Reserve	10,00,000	Stock, Book Debts, etc.	10,00,000
Liabilities	8,00,000		
Profit Balance ..	2,00,000	Investments (out of Reserve Fund) ..	5,00,000
	30,00,000		30,00,000

Now watch the entries. Although Rs. 5 lakhs have been removed from the investment out of reserve fund, the reserve fund continues to remain at Rs. 10 lakhs. Some companies prefer to leave it as it is and some "capitalize" that portion which has been so utilized. That is, shares are issued to the extent of Rs. 5,00,000 to the existing shareholders as free or Bonus shares. In the latter case the balance sheet will show the reserve fund at Rs. 5,00,000, increasing the paid-up capital by the corresponding amount.

The funds and liquid assets are confusing to a lay mind. It is believed that the total of these two items represents the strength of the

company. This is a popular misconception. Admittedly, the liquid assets of a company indicate its solidity, but the funds are not a separate portion of assets in addition to the liquid assets. They are, broadly speaking, a provision made to meet known or anticipated waste, liability (contingent or otherwise), loss, etc., or to retain a portion of profits in business in order to strengthen it financially. They may, therefore, be either obligatory or voluntary. They indicate to what extent certain emergencies can be met without interfering with the other finances of the company.

Whatever type of reserves a company may have, they do not necessarily represent cash or investments. Not even any specific portion of the assets of the company. These funds, with the exception of the depreciation fund, can be taken for real funds in liquid form only if their total corresponds with the liquid assets on the other side of the balance sheet. If the total value of the various funds exceeds that of the liquid assets then we must infer that the difference is employed in fixed or circulating assets or even in intangible assets, should the company have any.

The Depreciation Fund: The depreciation fund—also called Depreciation Account or Reserve for Depreciation—is again complicated to the untrained mind. It is thought that when such

an item exists in the balance sheet it represents some cash reserve. In reality, the depreciation fund is in the business and forms a part of the total assets of the company, particularly the expenditure involved (and added to the fixed assets) in the maintenance of the fixed assets in good order, including renewals and replacements. The company that shows such a fund on the liabilities side will show, on the assets side the gross value of block, that is to say, fixed assets at cost price as distinct from depreciated value. Where a depreciation or a similar fund exists, it will be observed that depreciation is not deducted directly from the value of the assets. Therefore, in order to ascertain the net value of the fixed assets of a company it is necessary to deduct from its value the amount of depreciation shown in depreciation reserve or depreciation account. Conversely, when no depreciation fund appears, the fixed assets are shown at " net " values, *i.e.*, after writing off depreciation necessary for offsetting the wear and tear of the fixed assets.

Freehold lands hardly require any depreciation, whilst leasehold require depreciation proportionate to their life. The percentage required for depreciation of different kinds of assets, such as plant, machinery, furniture, buildings, godowns, electric machinery and/or fittings, etc., etc., depends upon the life of such assets and

their estimated realisable value when they become unserviceable.

Profit and Loss Account: The profit is clearly the liability of a company to its shareholders and should be treated as belonging to the shareholders.

(b) Liability to the public: This is a very significant item and covers debentures, loans borrowed from banks and others, sundry creditors, etc.

Debenture Loans: A debenture holder is a lender of money to the company on interest, securing his loan by mortgage of company's properties. Generally he does not share profits of the company but charges it regular interest. If the company becomes unable to pay interest or principal on the due date then generally he takes possession of the company's assets in terms of his deed of mortgage and recovers his loan by realising the company's assets. The rights and privileges of debenture holders are always defined in the mortgage deed. Just as shares are equal portions of capital obtained by a company from the investors, debentures are equal portions of loans borrowed by a company from the public.

In order to avoid legal formalities and trouble in raising debentures, it is sometimes found convenient to borrow limited sums from banks, directors or Managing Agents. When a loan

is advanced by directors or Managing Agents without any security, one is inclined to believe that the makers have confidence in the working of the concern.

Sundry Liabilities: Just as there are sundry debtors who owe money to the company for goods sold to them, there are sundry creditors from whom the company bought raw materials or other goods. The sundry liabilities according to law are required to be distinguished between liabilities for goods supplied, for expenses, for unclaimed wages, for deposits or advances, for finances, etc., and are shown separately on the balance sheet for the information of the shareholders.

Some companies take security in cash or in other forms from the traders whilst some needy companies attract deposits from the public by offering attractive rates of interest so that they may have the necessary funds for the running of their business without paying exorbitant rates of interest to financiers. In any case, the investor should realise that the public are at liberty to withdraw their funds in terms of their deposits, and hence a temporary set-back in the company's earnings, or any unfavourable news, may lead such creditors to rush to withdraw their money, thereby seriously shaking the company's working structure from its very root.

CHAPTER IV

The Balance Sheet (*contd.*)

Having described some of the important items of the balance sheet, we will now proceed to analyse them, with a view to detecting the strong and the weak points that misguide the investors. But, before doing this, we must point out that, however informative a balance sheet may be, it does not indicate to the investor whether the company has made progress during the accounting year or not, although it shows the state of affairs on the specified date. Some companies have, therefore, recently started showing on their printed accounts corresponding figures of the previous year. In order to compare the present with its past results, the reader would be well advised to refer to certain reference books such as " The Investor's India Year-Book " (compiled by Messrs. Place, Siddons & Gough,) etc., wherein comparative figures for the last five to ten years are found, although in an abridged form.

From the outset it might be mentioned that a reader will derive maximum benefit from the reading of a balance sheet if he reads it with a critical mind so as to guide himself through many an intricacy of the balance sheet.

For the purpose of illustration we give below a balance sheet drawn incorporating features of interest. It has been arranged in such a way as to simplify our argument as far as possible and lead the reader through with considerable ease.

LIABILITIES.

CAPITAL		Rs.	Rs.
Authorized:			
25,000 Ord. shares of Rs. 100 each		25,00,000	
25,000 5% Cum. tax free Preference shares of Rs. 100 each.		25,00,000	
			50,00,000
Issued and Subscribed:			
20,000 Ord. shares		20,00,000	
10,000 Pref. shares		10,00,000	
			30,00,000
Amount Called and Paid up:			
20,000 Ord. shares on which Rs. 75 have been called up ..		15,00,000	
10,000 Pref. shares fully paid up.		10,00,000	
			25,00,000
4% *Mortgage Debentures:*			
Secured by a charge on fixed assets per contra			10,00,000
FUNDS			
(*a*) *Reserve Fund:*	Rs.		
As in last account ..	15,00,000		
Add Transferred from this year's Appropriation A/c. ..	3,00,000		
		18,00,000	
(*b*) *Depreciation Fund:*			
As in last account	24,00,000		
Add Realization of discarded machinery, etc.	10,000		
" Transferred from this year's Appropriation A/c. ..	1,90,000		
		26,00,000	
Carried over ..		44,00,000	35,00,000

ASSETS.

	Rs.	Rs.	Rs.
FIXED CAPITAL EXPENDITURE			
Immovable and movable property (at cost):			
Land		5,00,000	
Works and Buildings		13,00,000	
Machinery and Plant	32,05,000		
Less Sold	5,000		
		32,00,000	
			50,00,000
STORES & SPARE PARTS			
(As per Inventories certified and valued by Managing Agents).			
Stores at Works (at cost) ..		6,00,000	
Stores in Transit " ..		1,50,000	
Fuel at Works " ..		2,50,000	
			10,00,000
STOCK-IN-TRADE			
(As per Inventories certified and valued by Managing Agents).			
Finished materials (at cost) ..		12,00,000	
With Selling Agents		3,00,000	
			15,00,000
BOOK DEBTS			
Sundry Debtors considered good and in respect of whom the company is fully secured.		1,00,000	
Sundry Debtors considered good for whom the company holds no security other than the Debtors' personal security (including amount due from the Selling Agents) ..		11,50,000	
Sundry Debtors considered doubtful		50,000	
			13,00,000
Carried over ..			88,00,000

LIABILITIES—*contd.*

	Rs.	Rs.	Rs.
Brought forward ..		44,00,000	35,00,000
(*c*) *Dividend Equalization Fund:*			
As in last account	4,50,000		
Add Transferred from this year's Appropriation A/c. ..	50,000		
		5,00,000	
(*d*) *Investment Reserve A/c.*			
As in last account	4,00,000		
Add Transferred from this year's Appropriation A/c. ..	....		
		4,00,000	
(*e*) *Sinking Fund:*			
As in last account ..	5,00,000		
Add Transferred from this year's Appropriation A/c. ..	1,00,000		
		6,00,000	
			59,00,000
LOANS			
(*a*) *Secured:*			
Loans from Banks (cash credit secured by Stock & Stores).	5,00,000		
Interest accrued but not due.	1,000		
		5,01,000	
(*b*) *Unsecured:*			
Fixed Deposits	2,00,000		
Interest accrued but not due.	....		
		2,00,000	
			7,01,000
LIABILITIES			
For goods supplied		5,44,000	
For expenses		25,000	
Due to Selling Agents ..		28,000	
Unclaimed wages		2,000	
			5,99,000
PROFIT & LOSS A/c.			
Balance as per Appropriation A/c.			5,00,000
		Rs.	1,12,00,000

ASSETS—*contd.*

	Rs.	Rs.	Rs.
Brought forward ..			88,00,000
ADVANCES			
Prepaid expenses		25,000	
Advances to Staff		10,000	
Deposits with Government and Railways		1,65,000	
Other advances		1,00,000	
			3,00,000
INVESTMENTS	*Face Value.*	*Cost.*	
2¾% Govt. of India Loan 1948-52	4,00,000	4,02,000	
3½% Govt. of India Loan 1947-50	2,00,000	1,95,000	
3% U. P. Govt. Loan 1961-66.	1,25,000	1,23,000	
5% T. F. 1945-55 Loan ..	1,12,000	1,18,000	
3,000 Reserve Bank Ord. Shares.		3,00,000	
150 Imperial Bank Ord. (F.P.).		2,23,000	
300 Tata Power Ord.		2,70,000	
1,500 Tata Hydro Ord. ..		1,69,000	
			18,00,000
INTEREST ACCRUED ON INVESTMENTS			10,000
CASH & OTHER BALANCES.			
Cash in hand at Head Office ..		15,000	
Cash in hand at Works ..		30,000	
Cash in Transit		20,000	
In Current A/c. with Banks ..		2,25,000	
			2,90,000
		Rs.	1,12,00,000

On the "assets" side of the balance sheet the fixed assets amounting to Rs.50 lakhs have been shown at cost, but, on looking to the "liabilities" side of the balance sheet, we find that there is a depreciation fund valued at Rs.26 lakhs. As stated previously, it must not be assumed as a cash reserve. It is merely a setting apart of profits to provide against depreciated values of properties, plants, machinery, etc. It is almost always represented by assets other than cash. Since the reserve has not been shown by deducting it directly from the assets it is necessary for us to deduct this reserve of Rs.26 lakhs from the total value of assets amounting to Rs.50 lakhs, leaving a balance of Rs.24 lakhs, which, in reality, indicates the present book value of the fixed assets.

Next come stores and stock-in-trade totalling Rs.25 lakhs. In the normal course of business of this magnitude, it is quite natural for the items to appear in these dimensions. A point noteworthy in regard to these items is that they have been valued at cost. The principle controlling valuation of stock is to value it either at cost or market price (the price at which the goods can be purchased from the wholesale market and not the selling price) whichever is lower.

Book debts here appear to be neither more nor less and the details given reveal that out of

Rs.13 lakhs Rs.1 lakh is fully secured. Another Rs.11½ lakhs which apparently cover bills receivable are believed to be good. The balance of Rs.50,000 is shown as doubtful. Since there is no reserve created out of the profits for such bad debts the value may be ignored as of any substantial worth when reading the balance sheet.

"Advances" form a small portion of the assets and appear to be in the normal course of business, since they cannot be avoided.

Out of the entire liquid assets of Rs.21 lakhs, Rs.18 lakhs are represented by investments. Their market value on the date of the balance sheet was Rs.20½ lakhs so that there is a sort of hidden reserve here of Rs.2½ lakhs.

We will now turn to the "liabilities" side of the balance sheet. The paid-up capital of the company is Rs.25 lakhs and although the company could have easily called up the remaining Rs.25 per share on the ordinary issue amounting to Rs.5 lakhs, it has deemed it advisable to look for Debentures, which, on account of the solidity of the company's finances, have been raised at as low a rate of interest as 4 per cent. We therefore see Rs.10 lakhs of debentures secured by a mortgage charge on fixed assets of the company which are now worth Rs.24 lakhs. We

can also see that the debentures are well secured —naturally.

In the previous chapter we have attempted to say that whatever types of reserves a company may have, they do not necessarily represent cash or investments. In this case we will discuss later whether all these funds are substantiated by liquid assets.

The company has felt it necessary to create a dividend equalization fund in order to equalize future distributions. This item goes a long way to give strength to the ordinary shares of the company even if there is a set-back in the earnings for one or two years, because the shareholders know that the shortcomings will be made good by drawing upon this fund.

Again, the step towards the creation of an Investment Reserve comes only from a prudent board of directors. The object of this is to provide against the fall in price of investments at any future date. Such a reserve for Investment Trusts and Insurance companies is absolutely necessary.

The debenture issue has occasioned the creation of the Sinking Fund. The general practice of companies having debentures is to set apart a portion of profits towards a sinking

fund (sometimes called "Amortization Fund") expressly created for the purpose of redeeming debentures on maturity. The amounts allocated yearly for this purpose depend upon the size of the debenture loan and the number of years it has to run, but the practice generally adopted is to divide the total issue by the number of years, so that the resulting figure will indicate what equal amounts are necessary to complete a required fund in a given period. Thus, in the present case let us presume that the issue had the currency of 10 years. For the six years already past Rs.1 lakh has been set apart annually, leaving the balance of Rs.4 lakhs to be further allocated during the remaining four years.

Under the heading "Loans," there appears the sum of Rs.7,01,000, Rs.5 lakhs out of which were borrowed from Banks. Apparently, the working capital was not sufficient to meet the anticipated demand and therefore, it was necessary for the company to borrow this amount. Such loans are usually secured by a first mortgage on assets and are given on short terms only. In the case where a company's financial position is sound, this item may not in the least worry the critic but when it appears in the balance sheet of a company which is somewhat financially embarrassed, the critic should pause and see how this compares with the liquid position and whether there are enough good and secured debts

outstanding, and stocks which, when realized, might enable the temporary loan to be repaid on short demand.

The items under the head "liabilities," sometimes called "Sundry Creditors," may represent various sundry items of debt owed by the company, the most important of which is the liability for goods and raw materials, etc., supplied to the company. The smaller the amount of this item the better it is.

The balance of Profit and Loss Account shown on the "liabilities" side of the balance sheet is transferred from the Appropriation Account and we will look into this later on. It appears on the liabilities side when there is a surplus of profits and on the assets side when it is otherwise.

Having described all the items of the balance sheet we will now proceed to dissect the balance sheet by placing various items under the groups suggested in the foregoing chapter with a view to finding out the financial position of the company. Let us, therefore, divide the assets and liabilities under the following heads: The assets under (*a*) Fixed, (*b*) Circulating, (*c*) Liquid and (*d*) Intangible; the liabilities under (*a*) the Shareholders and (*b*) the Public. This will reveal the magnitude of assets and liabilities in a clear form.

The balance sheet when summarised will appear as follows :—

LIABILITIES.			ASSETS.		
To the Shareholders.	Rs.	Rs.	*Fixed (at cost).*	Rs.	Rs.
Ordinary and Pref. capital	25,00,000		Land, Buildings, Machinery, etc. ..		50,00,000
Reserve and other Funds including depreciation ..	59,00,000		*Circulating.*		
Profit & Loss A/c. ..	5,00,000		Stores & Spare parts ..	10,00,000	
		89,00,000	Stock-in-trade.	15,00,000	
To the Public.			Book Debts ..	13,00,000	
Debentures ..	10,00,000		Advances .	3,00,000	
Loans from Banks, etc..	7,01,000				41,00,000
Sundry Creditors ..	5,99,000		*Liquid.*		
		23,00,000	Investments .	18,00,000	
			Interest accrued on investments	10,000	
			Cash & other balances .	2,90,000	
					21,00,000
			Intangible ..		..
		1,12,00,000			1,12,00,000

What is the total liability to the public? The second item of the above statement shows what it is, but out of the Rs.23 lakhs, Rs.13 lakhs only is the immediate liability, the debenture capital not being repayable until 4 years hence. The company's liability to the shareholders on account of the capital is formal and cannot be evoked until and unless the company goes or is forced into liquidation, or when a drastic reconstruction of the capital takes place. But under normal circumstances, the liability should be taken for all intents and purposes as deferred. Similarly the shareholders may be assumed to have no real access to the funds, with the

exception of the reserve and dividend equalization funds, out of which they may suggest the directors to pay an increased dividend or cash bonus.

Let us now see what the financial position of the company is from the above figures.

	Rs.
Circulating Assets	41,00,000
Liquid Assets	21,00,000
	62,00,000
Deduct—Debenture & current liabilities	23,00,000
	39,00,000
Deduct—Reserve & other funds (excluding Depreciation Fund)	33,00,000
Surplus over liabilities	6,00,000

It will be noted from the above that after deducting the debenture and current liabilities from the floating assets there remains a balance of Rs.39 lakhs. Such a position should entirely satisfy the creditors of the company. Now, after deducting the company's liability to the shareholders, in respect of the various funds with the exception of the depreciation fund, there still remains the sum of Rs.6 lakhs. We have seen that the Profit & Loss Account shows to its credit Rs.5 lakhs, and, therefore, the remaining assets will serve to pay off any dividends declared.

It is evident from the foregoing figures that the financial position of the concern is quite sound, the company being well in a position to liquidate immediately its current liabilities even including that to the debenture holders, should the occasion arise.

Again, from these figures we can work out the Working Capital by adopting the following method :

	Rs.
Circulating & Liquid Assets ..	62,00,000
Less—Current Liabilities ..	13,00,000
	49,00,000
Deduct—Dividends payable (say)	3,00,000
Working Capital	46,00,000

In the event of a dividend being declared the amount so payable should be deducted from the difference between Circulating and Liquid Assets, and Current Liabilities as indicated above, the sum of Rs.3,00,000 being the supposed dividends deducted for the purpose of indicating the correct method of arriving at the Working Capital.

The Profit and Loss Account which is always attached to the balance sheet is of importance to study the working of a company for the year for which it is published. It shows clearly item by

item, the income for the year on one side and the expenditure on the other, and the critic can without much difficulty compare the two sides, and ascertain whether the ratio of expenditure is unduly high or low.

Some companies, for the purpose of enabling the shareholders to ascertain the trading results and the gross profit earned, divide the Profit and Loss Account into two parts, and show the Trading Account before the Profit and Loss Account, whilst all of them show appropriations in the balance sheets, showing how profits are disposed of. The year's balance, together with the previous year's balance brought forward from the last year's account, is placed on the balance sheet on the liabilities side if it is a surplus or on the assets side if it is a loss. It is out of the credit balance shown on the liabilities side that the dividends and other rights are paid out.

It will be seen, therefore, that the figure shown by the Profit and Loss Account is not, as is sometimes supposed, the profit for the year, but only the balance. Before arriving at the net figure of the profit, the investor should remember to deduct depreciation and taxes where they are not provided.

CHAPTER V

The Balance Sheet *(contd.)*

So far, we have dealt with a "good" balance sheet only which invariably covers good points of a company and we cannot conclude this unusually long chapter before peeping into a "bad" balance sheet because it is here that we get to learn a lot. Therefore, to illustrate our purpose, we will take the following balance sheet, drawn in a somewhat abridged form, solely for the purpose of saving space. We will assume that this balance sheet is of a company 20 years old.

LIABILITIES.	Rs.	Rs.	ASSETS.	Rs.	Rs.
Capital		10,00,000	*Fixed Assets (at cost).*		
Funds.			Land	3,00,000	
Reserve ..	5,00,000		Buildings ..	5,00,000	
Depreciation..	5,00,000		Plant and Machinery..	15,00,000	
		10,00,000			23,00,000
Loans.			*Stores & Spare parts (at cost)* ..		6,00,000
Secured ..		5,00,000	*Stock-in-Trade (at cost)* ..		4,00,000
Liabilities.			*Book Debts.*		
Goods supplied	8,00,000		Considered good ..	1,00,000	
For Expenses.	2,00,000		Considered doubtful ..	50,000	
Due to Managing Agents	5,00,000				1,50,000
		15,00,000	*Investments (at cost)*		
Profit & Loss A/c.		1,00,000	"A" Subsidiary Co. ..	1,00,000	
			"B" Subsidiary Co. ..	50,000	
					1,50,000
			Cash and other balances ..		1,00,000
			Goodwill, Trade Marks, etc. ..		4,00,000
		41,00,000			41,00,000

To a layman it would appear that the company is sound financially in view of the fact that the Funds amount to as much as the capital itself. But whether the company is really sound as it looks, will be seen by summarizing the balance sheet in the manner we have done before, that is :

LIABILITIES.	Rs.	Rs.	ASSETS.	Rs.
To the Shareholders.			*Fixed Assets.*	
Capital ..	10,00,000		Fixed Assets at cost ..	23,00,000
Funds including Depreciation ..	10,00,000		*Circulating Assets* ..	11,50,000
Profit & Loss A/c. ..	1,00,000	21,00,000	*Liquid Assets* ..	2,50,000
To the Public.			*Intangible Assets* ..	4,00,000
Loans	5,00,000			
Sundry creditors ..	15,00,000	20,00,000		
		41,00,000		41,00,000

To analyse the figures further we will arrange them in the following manner :—

	Rs.
Liability to the Public	20,00,000
Deduct—Circulating and Liquid Assets	14,00,000
Balance of liability to be met from the fixed assets ..	6,00,000

Against the total liability to the public of Rs.20 lakhs stand the circulating and liquid assets of Rs.14 lakhs only, showing a deficit on this item alone of Rs.6 lakhs. Besides, though there is the reserve fund of Rs.5 lakhs and the

balance of undistributed profits of Rs.1 lakh, we do not find any corresponding tangible asset to represent these two items amounting to Rs.6 lakhs.

If the circulating and liquid assets are fully realised and paid to the creditors there still remains a balance of Rs.6,00,000 to be paid to them which must now be met from the fixed assets. Looking to the age of the fixed assets which are not depreciated they might not be able to realise more than 20 per cent. of its worth. If so, the balance of liability of Rs.6 lakhs will be in excess of the 20 per cent. value of the fixed assets.

This is the position we arrive at after the preliminary examination of the balance sheet, but on turning to the actual figures we find that for the whole period of 20 years only Rs.5 lakhs have been provided for the maintenance in original working order of the fixed assets (depreciation fund) when at the very least 2½ per cent. per annum on the buildings and 5 per cent. on the plant and machinery should have been provided for, in the ordinary course of business. On the other hand, the company has constantly added to the fixed assets, extra expenditure incurred in connection with the renewals and extensions.

Taking depreciation as above we get Rs.17,50,000 for 20 years indicating that the

provision of Rs.5 lakhs, so far made, is absolutely inadequate. Yet, as we remarked before, in spite of there being a reserve fund of Rs.5 lakhs it was not separately invested outside the business and we find no earmarked securities representing the said reserve. In our estimate of the balance of liabilities to the public amounting to Rs.6 lakhs, we have assumed that the entire circulating and liquid assets would realise their full book value. Even in such a case there is no further easily realisable asset left to represent the reserve and the balance of profit, and hence the balance of liability to the public (*viz.* Rs.6,00,000) must be met out of the fixed assets worth Rs.23,00,000 less Rs.17,50,000 for depreciation (*i.e.*, Rs.5,50,000 net value of the fixed assets) and out of the value of goodwill, Trade Marks, etc. It will be realised by the reader that when biggest of concerns are sold outright or are liquidated, they very often lose the value of goodwill entirely and such values if shown on any balance sheet must be accepted by the investing public with the *utmost caution*.

It will be argued that depreciation of Rs.17,50,000 has been the result of 20 years on Rs.23,00,000 worth of fixed assets, whereas the initial outlay could not have exceeded Rs.9,00,000 since the capital is Rs.10,00,000; the balance Rs.14,00,000 being the value of additions to the fixed assets, from year to year, within the period

of 20 years, thus necessitating lesser depreciation. It is true. But we must not lose sight of the fact that where 5 per cent. depreciation on buildings and 10 per cent. on machinery was advisable, we have taken only 2½ per cent. and 5 per cent. respectively so that the ultimate results yielded by the two methods will not vary widely.

Loans to the extent of Rs.5 lakhs have been borrowed on security in order to stave off trading difficulties. In this case the money has been advanced on first charge on all the available assets of the company leaving the company to face the serious situation arising in the event of the security being enforced.

Under the item "liabilities" we notice another item of Rs.5 lakhs due to the Managing Agents. In a case like this it can safely be inferred that the company was unable to pay full or part commission and other charges due to the Managing Agents during the past few years.

On the assets side there appears an item of Rs.6 lakhs for Stores and Spare parts. Such items usually help the liquid position of the company when put on the balance sheet, but here, on the corresponding side we see that there is a liability for goods supplied of Rs.8 lakhs which cancels entirely the stock assets of Rs.6 lakhs. Companies with scanty finance sometimes purposely keep the suppliers' bills unpaid

which fall due at the time of the closing of the accounts in order to make the ignorant public believe that their liquid position is better than it is.

There is another interesting feature in this item. It is the value of stores and spare parts which is taken at cost. What the market value of this item was on the date of the balance sheet is difficult for the public to know. In this connection the critic would be well advised to read the Auditors' Certificate on the balance sheet and to ascertain whether the Auditors have qualified their certificate by any reference to the value of stores and stock. Though it is the accepted and universal practice of the Auditors to watch against the inflation in value of stores and stock, sometimes it may happen that the certificate is not qualified only because the stores and stock have been valued at cost. In all cases where the stores and stock are valued at market price the Auditors satisfy themselves that such market value is less than the cost price. However, we must remember that Auditors do not accept responsibility for the values placed upon fixed and circulating assets, and they do not certify their values since these are generally matters not of actual fact but of opinion.

In the case we have mentioned we have taken into consideration the several assets at

their face value, but since our suspicion has been aroused by the inadequate allowance for depreciation, we would not be far wrong if, for the purpose of reading the balance sheet, we were to write at least 5 per cent. off the value of the circulating assets. This will mean that the current value of the said assets will be reduced to Rs.9,50,000 (*i.e.*, Rs.6,00,000 for stores and Rs.4,00,000 for stock=Rs.10,00,000, less 5 per cent.=Rs.50,000), and the balance of liability to the public correspondingly increased, now making it Rs.6,50,000 instead of Rs.6,00,000.

Generally, where there is no reserve for bad or doubtful debts the item of doubtful debts is shown in balance sheets after writing it down to the extent it is deemed advisable but whenever a balance sheet of an unsound concern includes debts considered bad or doubtful, it would be advisable to deduct at least 5 per cent. from this item, and in this case we will deduct 5 per cent. from Rs.50,000 leaving Rs.47,500 which we will assume is the realisable value of the doubtful outstandings.

Contrary to expectations, we see that the Investments are shown at cost. It is good. But when? When the market price is above the cost price. In this case we do not know what exactly the cost price of the shares is, for they are not quoted on the Stock Exchange. But there

is a clue to find out roughly the market value of these holdings. On turning to the Profit and Loss Account (not given here) we find that the dividend received on the investments for the last full year is Rs.3,000 which on the total cost price of Rs.1,50,000 works to 2 per cent. only. It is evident from this that the holdings are not so good as the yield given by similar shares quoted on the Stock Exchange ranges from 6 to 8 per cent. Assuming that the shares of this nature give a 6 per cent. yield, the total market value of the holdings must fall from Rs.1,50,000 to Rs.50,000 to yield 6 per cent. Therefore, we will take into account Rs.50,000 instead of Rs.1,50,000.

This is not all. The two companies in which investment is made are subsidiary or allied concerns whose shares are difficult to sell. Even if it were possible to sell them they would not be sold, for the object of such investments is to derive a mutual trading benefit and hence the investments are of a permanent nature. The success of the subsidiary companies depends upon the parent company and the investments should, therefore, be treated as fixed rather than liquid assets.

Goodwill, Trade Marks, etc., form another burdensome item to the company. We will assume that for the last 20 years nothing has

been written off towards this intangible asset. It is not unjust to consider that 10 per cent. per annum is reasonable for the purpose of writing off this item but even assuming that 5 per cent. is the bare minimum, the balance sheet should not have shown this item of assets.

Summarizing our criticism we come to the position as disclosed by the following balance sheet re-arranged incorporating the conclusions we have just arrived at.

LIABILITIES.	Rs.	Rs.	ASSETS.	Rs.	Rs.
			Fixed Assets (at cost)		
Capital .		10,00,000	Land . .	3,00,000	
Funds.			Buildings ..	5,00,000	
Reserve .	5,00,000		Plant & Machinery ..	15,00,000	
Depreciation .	17,50,000				23,00,000
		22,50,000			
Loans.			*Stores & Spare Parts (at market value)*		5,70,000
Secured ..		5,00,000			
Liabilities.			*Stock-in-Trade (at market value)* .		3,80,000
To goods supplied .	8,00,000				
For Expenses.	2,00,000		*Book Debts.*		
Due to Managing Agents	5,00,000		Considered good ..	1,00,000	
		15,00,000	Considered doubtful ..	47,500	
					1,47,500
			Investment (at market price of similar shares)		50,000
			Cash & other balances .		1,00,000
			Goodwill, Trade Marks, etc. ..		
Total		52,50,000	Total		35,47,500
			Deficit ..		17,02,500
		52,50,000			52,50,000

From the above we can gather that, in addition to the available finances of the company being in a mess, the deficit amounts to Rs.17,02,500 as opposed to Rs.1,00,000 shewn

to the credit of Profit and Loss Account. No doubt, we have deducted for depreciation and goodwill in one year what might have been advisable to do over a series of years but this drastic reconstruction shows roughly what the financial position of the company should be to-day.

We can gather further facts by again summarizing the figures as follows :—

LIABILITIES.	Rs	Rs.	ASSETS	Rs.	Rs.
To the Shareholders.			*Fixed Assets*		
Capital	10,00,000		Fixed assets at cost	23,00,000	
Funds (excluding Depreciation) ..	5,00,000	15,00,000	Less value of Depreciation Fund	17,50,000	5,50,000
To the Public.			*Circulating Assets*		10,97,500
Loans	5,00,000		*Liquid Assets*		1,50,000
Sundry Creditors ..	15,00,000	20,00,000	*Intangible Assets*		*Nil*
			Deficit ..		17,02,500
		35,00,000			35,00,000

Out of these figures we get the following :—

	Rs.
Liability to the Public	20,00,000
Deduct Circulating and Liquid Assets	12,47,500
Balance of liability to be met from the fixed assets ..	7,52,500

The balance of liability to the public to be met out of the remaining assets of the company is Rs.7,52,500. The remaining assets of the company, it will be noted, are fixed assets only,

the current value of which is only Rs.5,50,000. This shows in a clear way that the company not only has no working capital but also requires additional Rs.7,52,500 to meet only the current liabilities plus Rs.9,50,000 in liquid form to make good the deficit, to form the working capital, and thus to come out of the financial tangle. It also emphasizes another point we have already stressed before, *viz.*, that the reserves do not always represent the strength of the company unless they are convincingly substantiated by tangible assets. It does not necessarily mean that they should represent cash or other circulating assets forming the working capital of the company. Reserves of even the soundest companies are spent on capital expenditure but it is up to us to see whether they help increase the profits or retard them.

The foregoing, we suppose, is also enough to convince us that certain given figures can be made to show what exactly the management wants to, but their acceptance rests with the critic.

This much for the balance sheet. We have said less about Profit and Loss Account because we are more concerned with the financial side of the company than its trading side, but the following words on Profit and Loss Accounts taken from Mr. L. Cuthbert Cropper, F.C.A.'s

book on "Higher Book-Keeping and Accounts" —*the textbook in* Accountancy of the Incorporated Secretaries Association—will be helpful to the critic while reading a balance sheet and Profit and Loss Account.

> "Limited companies rarely publish Trading or Manufacturing Accounts, and there is a growing tendency to publish Profit and Loss Accounts as greatly abbreviated as ingenuity can devise and the law permit. The result is that many items which, in theory, should appear in the Profit and Loss Account are charged in the Trading Account, and are thus hidden from observation. It should be remembered that, unless the form of the Profit and Loss Account is prescribed by Statute, the manner of its presentation is entirely at the discretion of the directors, and the auditor cannot impose his views unless, of course, the account it is proposed to publish is inaccurate or misleading."

Before proceeding further we must emphasize the importance of reading a balance sheet in conjunction with the Directors' report attached thereto and the Chairman's speech at the ordinary general meeting, if available. They are very helpful to investors because they throw a lot of light on the past, present and future trend of the business of the company.

CHAPTER VI

Investment In Ordinary and Deferred Shares

We think we have now qualified ourselves to take in hand the question of the investment of our savings by having as much information as space would permit on the vital points of the balance sheet. This has also shown us how a company's strength and weakness can be judged within a very short time without having recourse to any outside information and how we can know first and foremost, whether it is worth our while to give any consideration to the concern we are interested in, and having thus prepared the ground for taking in hand more critical work, we will proceed.

To cut our work short we will not go to see how a company is floated with all the procedure connected therewith and how the shares come into existence. We will also avoid all the intricacies connected with the formation of a company and approach our subject directly.

Generally, the capital of Joint Stock Companies is divided into three parts, *viz.*, Ordinary, Preference and Deferred shares. We will examine the preference shares in the following chapter which has been allocated for that

purpose and discuss here, as far as possible, the other two classes of shares, *viz.*, ordinary and deferred.

Where the preference and/or deferred shares form part of the capital of a company, the portion of capital for which no fixed provision of distribution is made, is known as Ordinary Capital. The subdivisions of this capital are known as Ordinary shares. Where there are no deferred shares, or where the preference shares are not entitled to preferential treatment in so far as surplus profit is concerned, the ordinary shares carry the right of sharing the entire distributable profit, *i.e.*, after preference shareholders are paid their fixed rate of interest and after adequate allocations have been made to the various funds a company may have. In the case of winding up they stand last for repayment of capital for they have no preferential claim for the repayment of capital.

Ordinary shares are not just ordinary as the word suggests. They are the life-line of the industry. As a matter of fact the entire structure of the industry rests upon the ordinary capital without which we cannot have enough money to build up cheaply sufficiently large industries, develop them for the sake of self-sufficiency and sell goods abroad to increase wealth.

The ordinary shareholders are, as it were, the propeller of the industry, but they have no fixed and assured reward for the work they do. They rank for dividend as much after preference shareholders as for the distribution of the remains of a liquidated company. On the other hand, the preference shareholders get out of the profits no more than what has been provided for by the Articles of Association of the company concerned and, therefore, any surplus profit that remains after satisfying the preference shareholders and providing for depreciation and taxation is, roughly speaking, the earnings of the ordinary and of the deferred or founders' shares. But the entire surplus is not divided amongst these classes of shareholders. Some of it is appropriated to various funds, as the directors may deem necessary, as a provision for lean years. Some of these shares receive large dividends. Some receive no dividends for a number of years and many do not receive any at all.

The ordinary capital is sometimes subdivided into classes such as Preferred Ordinary Shares, "A," "B," etc., ordinary shares, and while there is no appreciable difference between these classes, they are differentiated for the purpose of certain identification. For example, the Preferred, "A" and "B" ordinary shares of the Titaghur Paper Mills Co., Ltd., came into

existence in the year 1937 when the capital of the company was reorganised. Amongst other classes of shares, this company possessed ordinary shares of Rs.2-8 each fully paid up, and deferred shares of Re.1 each, also fully paid up. In 1937, the ordinary shares were converted into Preferred Ordinary shares. The deferred shares were consolidated by merging every five shares into one of Rs.5 and converted into "B" ordinary shares of Rs.5 each. Further, the reserve fund was capitalized and subdivided into "A" and "B" ordinary shares each of Rs.5 and these were issued free as capital bonus to the existing ordinary and deferred shareholders respectively, in certain proportion. The "A" and "B" ordinary shares rank *pari passu* with each other in all respects with the exception of voting power. The preferred ordinary shares are entitled to a fixed preferential tax-free dividend of 10 per cent. per annum out of the profits available for distribution, after paying interest on debentures and fixed-interest to preference shareholders, and in winding up carry preferential claim to the assets in accordance with the provisions made in the Articles after, of course, the preference shareholders are satisfied. Both classes of ordinary shareholders are equally entitled to the surplus assets. This practical example will serve to make us understand the difference between the various subdivisions of ordinary capital.

When it is felt that a certain scheme can be profitably exploited or a certain device be developed, a few financiers get together and with the help of technicians make a thorough research of the possibilities and when sufficiently convinced that there is money in it, proceed to raise capital by means of public subscription. Before coming to this stage they will have, naturally, spent a lot of money by way of fees to Consulting Engineers, travelling expenses, chemical analysis, etc., and in order to compensate themselves for the risk that they have taken, they form a privileged class of shares for themselves generally known as Founders' or deferred shares. These carry the right of sharing disproportionately with ordinary shares—though in accordance with the provisions made in the Articles,—the profits remaining after satisfying preference and ordinary shareholders.

The deferred capital is almost always a small fraction of the entire capital and far less than the ordinary capital. So also they are small in denomination as compared with the ordinary shares but stand to get larger dividends if the earnings are very great, as the following example will show.

The subscribed and paid up capital of the Indian Steel and Wire Products Ltd., which is Rs.22,26,580, is divided into 170,000 ordinary

shares of Rs.10 each fully paid up; 26,500 ordinary shares of Rs.10 each on which Re.1 only has been called up and 200,000 deferred shares of Rs.2-8 each fully paid up. The Articles of the concern provide that after payment of 6 per cent. per annum on ordinary shares, the deferreds are entitled to half the surplus profits, the other half being again distributable amongst the ordinary shareholders.

Last year this company earned Rs.22,04,811, out of which the sum of Rs.9,14,889 was allocated to depreciation and reserve funds leaving in hand Rs.12,89,922 out of which after deducting Rs.1,03,595, being the 6 per cent. dividend on ordinary capital there remained Rs.11,86,327. Out of this amount, Rs.12,253 was carried forward and the remaining amount of Rs.11,74,074 was divided equally between the ordinary and deferred shareholders, so that half of this amount which is Rs.5,87,037 plus Rs.1,03,595 amounted to Rs.6,90,632, this being the total amount received by the ordinary shareholders during that year; whereas deferred capital which is less than one-third of the ordinary capital received Rs.5,87,037 amounting to 117.4 per cent. against 40 per cent. received by the ordinary capital.

The ordinary shares of a new concern do not come to the dividend earning stage until the company has overcome preliminary difficulties

although some new companies before have, from the very first year of operation, paid a small dividend; which is as much as to say that they have squandered the little profits they had made in order to maintain the shares which had risen in proportion to the anticipations of dividends forecast in their puffed-up prospectuses. It is difficult to judge when a new company will reach the dividend paying stage, it all being dependent upon the lines on which it is formed and the nature of its business. Some are entirely new undertakings formed for the purpose of starting a new business, and a company of moderate dimensions generally takes about one to two years to commence operations, in which case at least further three years should be added to find out, fairly correctly, how it will fare.

But it is a different case if the company is formed to take over an existing business of private owners or of a concern in liquidation or of several concerns in the same industry for the purpose of economical trading. In the case of the company floated for such purposes the law requires that the prospectus should state the profits accruing from such business during each of the three years immediately preceding the issue of the prospectuses or during each year of the existence of the business if less than three years, so far as the information is available, in the form of a balance sheet, so that from this

record and in conjunction with the terms of the vendors, we can, more or less, judge the footing a new concern of this type has.

It is almost always difficult to judge the prospects of ordinary shares of a new company floated to start a new business. (1) Primarily, it depends upon the nature of the business and whether it is a new field or a new entrant into an already existing one. (2) Then come the Promoters, Directors and the management. This is important because not infrequently the failure or success of a new venture depends upon the business acumen of the men at the helm. (3) The next factor is the geographical situation of the industry and under what government or state it comes. (4) The last, but not the least, is the classification and arrangement of capital.

The first two do not require clarification as they are self-explanatory. The last two, although not so important to a new undertaking, are vital to an old one and we will, therefore, dilate on the points to the necessary extent.

To illustrate the importance of the geographical situation of an industry and what bearing it has when it falls under different governments, we will take a practical example of the sugar industry. The soil of the United Provinces and Bihar is eminently suited for the sugar cane culti-

vation and, therefore, many sugar factories have sprung up in these two Provinces, which can be called the heart of India's sugar industry. From these places the production has to be carried hundreds of miles away to every corner of India so as to serve all the sugar consuming public with the consequence that the costly rail transport which naturally increases the selling price, cuts considerably into profits. There are, besides, a few sugar factories outside these provinces which are well in a position to serve the public around them at or slightly below the price at which the factories of the above two provinces can afford to sell in the area of these outside factories, thereby, indirectly charging the consuming public the transport charges which do not exist. In other words, suppose the cost of sugar at factory is Rs. 11 per cwt., the selling price ex factory being Rs. 13-8-0. If the factories in the U.P. and Bihar have to sell their production in or around Belapur, the selling price f.o.r. Belapur after adding railway freight and handling charges which, let us suppose, are Rs. 4 per cwt. will amount to Rs. 17-8-0 per cwt. But Belapur already has one factory whose cost of production cannot be very much different. If this factory, assuming that the quality of the sugar is the same, sells at a slightly lower price than that we have arrived at above, this will mean: profit of Rs. 2-8-0 plus Rs. 4 = Rs. 6-8-0 per cwt. (or

slightly lower than that for the purpose of competition), whereas the factories of Bihar and U.P. will get only Rs. 2-8-0 per cwt. for their production in Belapur or elsewhere.

To supplement our argument we will take concrete figures. Five *good* companies in the U.P. and Bihar, *viz.*, Cawnpore, Champaran, South Behar, Balrampur and Basti, the capitals of which aggregate about a crore of rupees, are selected for comparison with four " outsiders," *viz.*, Belapur, Buland, Raza and Mysore whose capitals also total about a crore of rupees. Their earnings for the last five years are given below in a tabular form and one can, at a glance, see the wide difference between the earnings.

	1936	1937	1938	1939	1940
1. Percentage earnings of 5 *good* U.P. and Bihar Sugar Companies ..	25·8	14·8	16·3	12·9	8·4
2. Percentage earnings of 4 " outsiders " ..	31·4	19·0	25·5	37·3	45·7

It may be contended that the figures of the Mysore Sugar Company influence the wide discrepancy in the above figures on account of its very high earning power. No doubt, they render substantial assistance to the figures in item (2) but even without the figures of this company the difference would be striking. Besides, all the companies in item (2) with the exception

of Belapur Sugar Co., are state aided and, therefore flourish more than those in item (1) which are also protected by the Government of India but there being too many entrants in the field in those areas, consequent internal competition, and sugar cane price control, a few only earn enough. Admittedly, this is a crude way of illustrating our point of argument, but it is the most effective one.

We will now take in hand the point of classification and arrangement of capital. The purpose of offering preference shares and debentures to the public is generally to attract as large a capital as possible in order to ensure the success of a flotation. The proportion of ordinary capital to the preference and debenture capitals together with the rate of dividend and interest, is of great importance to both the preference and ordinary shareholders. The lower the rates of dividend on preference shares and interest on debentures, the better it is to ordinary shareholders. Large preference and debenture capitals during lean years are a disadvantage to ordinary shareholders because if the earnings are just about or below the rate of interest or dividend that has to be paid out, ordinary shares will hardly receive anything. Conversely, they stand at a considerable advantage during a boom. This will best be seen by an example. These examples to some may be boring, but nobody

will deny that they are the best media for grasping the significance of facts.

We will assume that a company has a capital of Rs. 10,00,000 divided into 7,000 5 per cent. preference shares of Rs. 100 each and 3,000 ordinary shares also of Rs. 100 each, all fully paid up. If owing to bad times the company's distributable profit was only Rs. 35,000, after satisfying preference shareholders there would remain nothing for ordinary shareholders. But if the capital was arranged the other way round, then preference shareholders would absorb only Rs. 15,000 leaving the balance of Rs. 20,000 or about 3 per cent. of the ordinary capital to be distributed amongst this class of shares.

It will be noticed what difference the arrangement of capital makes but it must be remembered that this is somewhat an extreme example. More preference capital is, no doubt, unfavourable to ordinary shareholders during lean years but it must also be remembered that it is exceedingly good during a boom for, again coming to our above supposition but with a divisible profit of Rs. 1,00,000, we get this. The total profit of Rs. 1 lakh represents 10 per cent. on the entire capital of the company which rate the ordinary shareholders are sure to get. But the distribution they receive is not 10 per cent. but about 22 per cent., and how? As we have

seen, the earning was 10 per cent. per share but the dividend payable to the preference share-holders is only 5 per cent. so that there is a surplus of 5 per cent. on the preference capital available to supplement the dividend on ordinary shares. This 5 per cent. works out to about 12 per cent. on the ordinary capital and this is how the ordinary shares get 22 per cent.

For the entire capital of a company to be in ordinary shares, on the other hand, is generally not in the interests of ordinary shareholders, for they do not enjoy the advantages given by the fixed interest capital we have just seen. The total distribution amongst all the classes of share-holders of the Tata Iron & Steel Co., Ltd., for the year 1941, as an example, was Rs. 2,42,19,267; the dividend received by the ordinary share-holders being Rs. 29 per share. Had the entire capital of this company been in the form of ordinary shares, these would have received only Rs. 17-6-0 per share an amount far less than that which has now been actually received by the ordinary shareholders.

Naturally, the profits earned by various types of companies vary considerably but all are subject to depression and it is left to the reader to apply his knowledge and judgment with the help of the available records of the past earnings when gauging this point of the company he is interested in.

Having studied, thus far, the various types of ordinary shares, we have prepared the ground for the discussion of the principles of sound investment in ordinary shares, and in the following and other chapters we will endeavour to deal with these comprehensively.

CHAPTER VII

Investment in Ordinary and Deferred Shares (*contd.*)

So far we have done nothing more than touch upon some of the important points of ordinary shares. We must now know how to find out *good* ordinary shares from an inexhaustible field. There are hundreds of good ordinary shares in India but the problem is not to discover what is good but to select what is suitable for the individual requirements as this is the foundation of investments. So let us go cautiously and discuss, as far as possible, in this chapter some of the relevant features of sound investment leaving others to be dealt with in other chapters allocated to that purpose.

The basis upon which an ordinary share should be judged is (*a*) the earning power of a company particularly in difficult years or under depression, (*b*) the financial position, (*c*) the nature of business, (*d*) future prospects, and (*e*) whether the yield compares favourably with that given by the ruling prices of the shares of the same class.

This is not all. Common sense judgment too is required, for an investor giving due regard

to these points and investing during a boom period will find his investments considerably depreciated during a slump, despite the company's ability to maintain dividends be it from profits or reserves. But a prudent investor who has not got all his capital invested in ordinary shares, be they high class or highly speculative, and who has a well planned investment, if unable to take advantage of the slump, will usually be in a position to ignore these temporary jolts and ultimately see that his investments have steered clear of all possible poignant shocks.

Ordinary shares, it has been said before, have no security and give no relative security to the price paid. From this it must not be inferred that all ordinary shares are risky. There are some which offer better security than preference shares and ordinary debentures, and for the purpose of discussion we shall make occasional reference to the several charts which have been provided for this purpose.

These charts have been prepared from the figures extracted from balance sheets, reference books, periodicals and the author's diary and show at a glance the position of various industries, group by group, for the last 15 years.

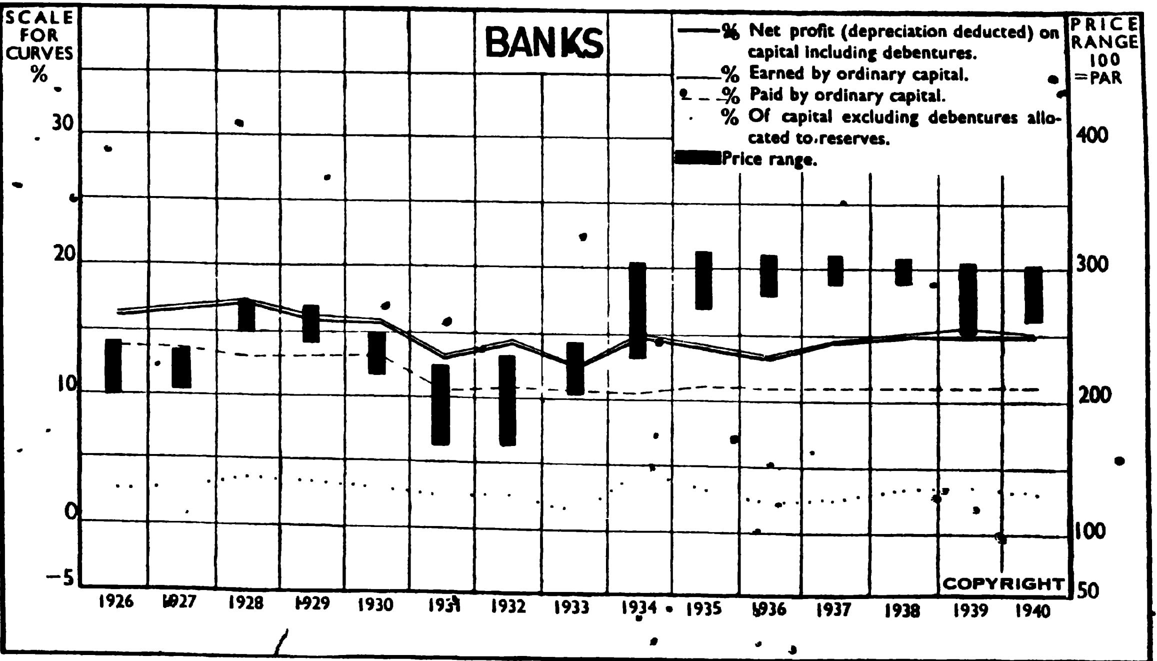
All these charts have, for the purpose of simplification, been drawn on the same basis with the exception of that for Jute Industry

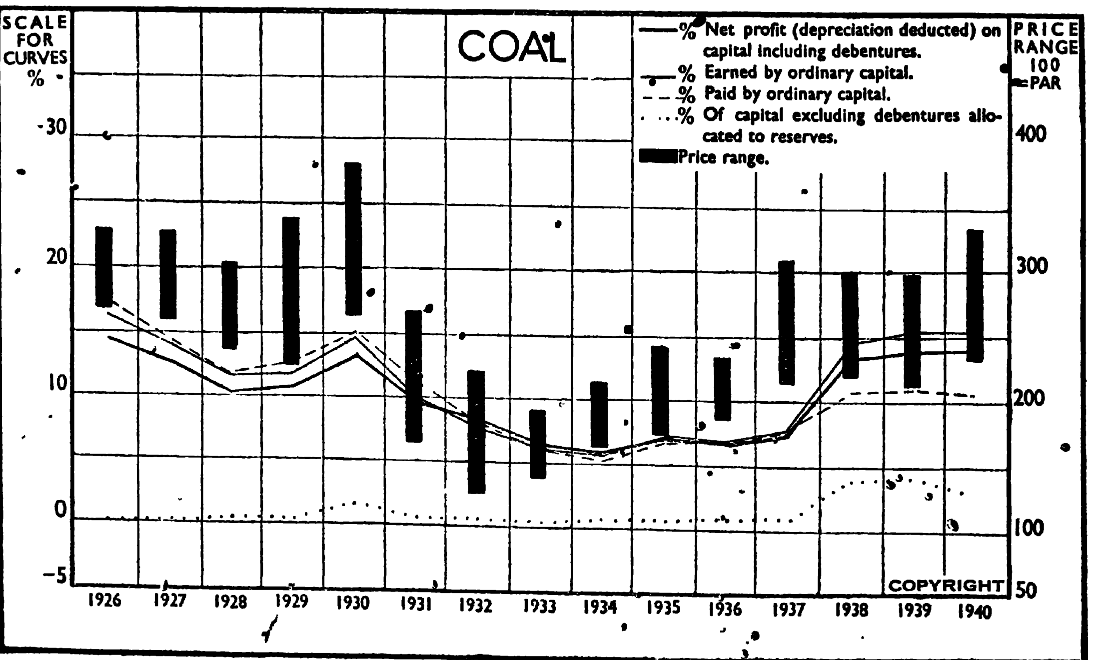
which, on account of wide fluctuations in earnings, distributions, price ranges, etc., necessitates reducing the scale to half.

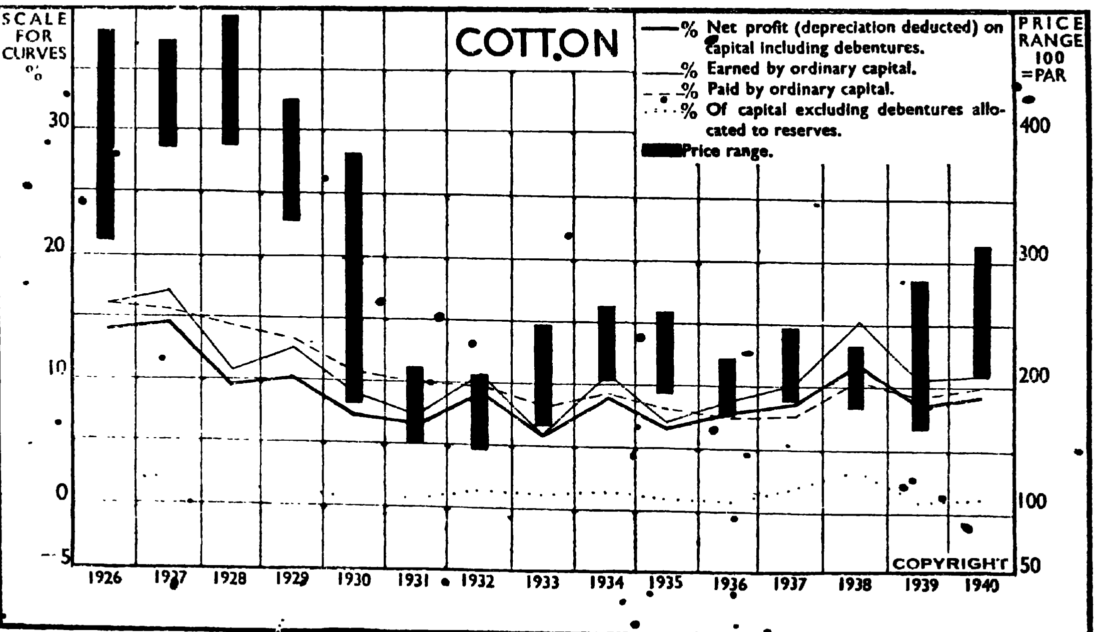
As will be seen, each chart has been arranged in such a way as to show distinctly percentage profit on capital, including debenture; earning on ordinary capital; payment on ordinary capital; reserve on capital, excluding debentures; and price range having 100 as the basis or par. It is hoped that this arrangement will obviate all possible difficulties generally met with while reading charts of this nature and provide the most vital information required to judge the general position of an industry.

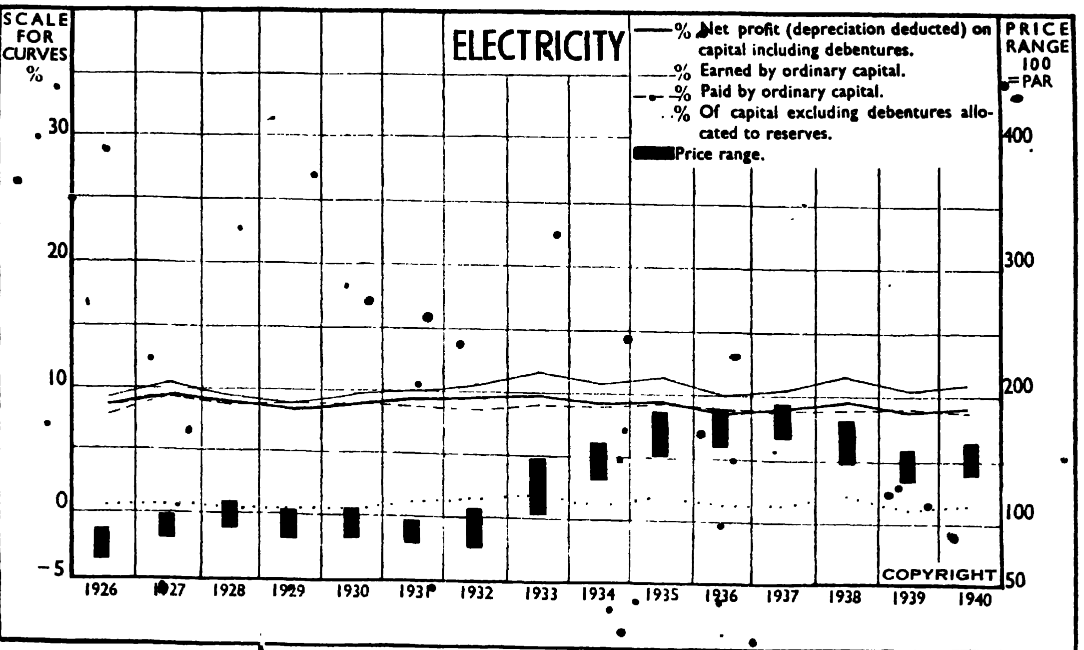
To make the reading of these charts still easier, one example will be enough. Let us take the Engineering industry illustrated in the respective chart given on page 80. In the year 1927 the profit earned by the entire capital, including debenture, was 15.2 per cent. the ordinary capital having earned 17.75 per cent. and paid 13.5 per cent. The percentage of 3.1 on capital excluding debenture was carried to reserves. The price range in that year, assuming Rs. 100 as par was: Highest Rs. 280; Lowest Rs. 185.

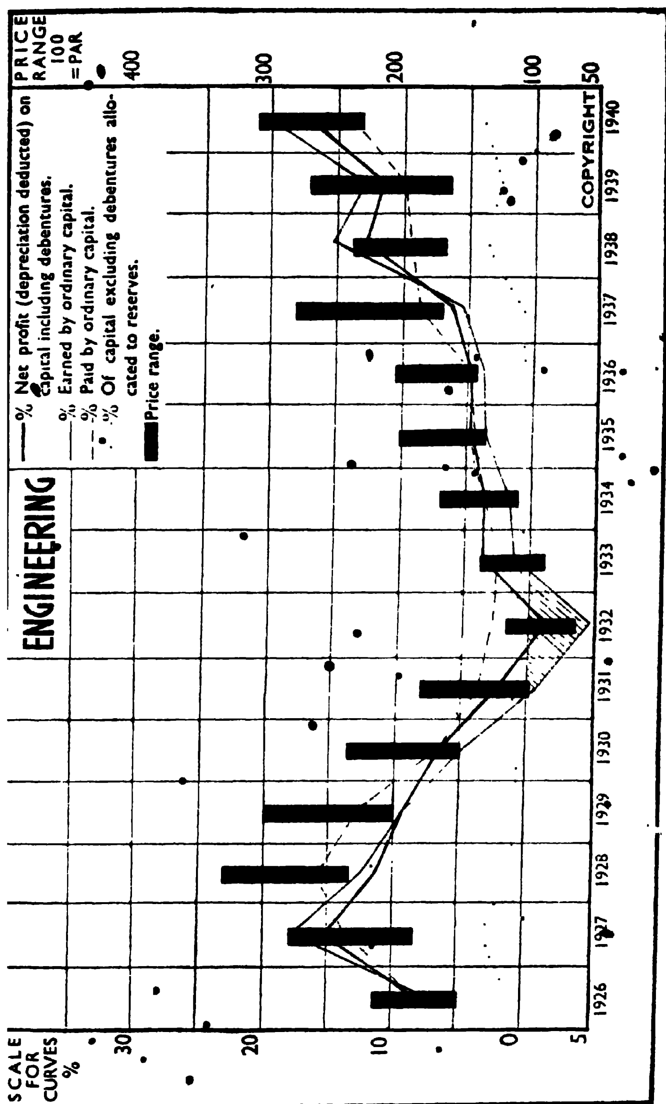
The Excess Profits Tax Act having been introduced after the outbreak of war, and on account of its lack of clarity and accounting


BANKS
SCALE FOR CURVES %
30
20
10
0
−5
PRICE RANGE 100 =PAR
400
300
200
100
50
% Net profit (depreciation deducted) on capital including debentures.
% Earned by ordinary capital.
% Paid by ordinary capital.
% Of capital excluding debentures allocated to reserves.
Price range.
1926
1927
1928
1929
1930
1931
1932
1933
1934
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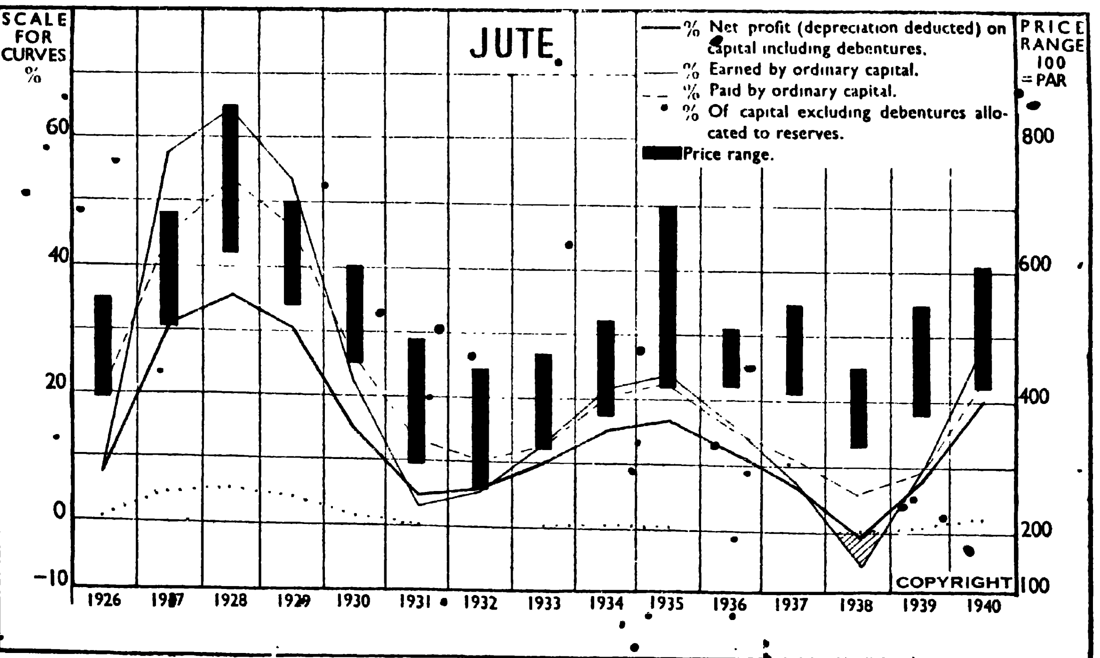

COAL
—% Net profit (depreciation deducted) on capital including debentures.
% Earned by ordinary capital.
% Paid by ordinary capital.
% Of capital excluding debentures allocated to reserves.
Price range.
PRICE RANGE 100 =PAR
400
300
200
100
50
SCALE FOR CURVES %
30
20
10
0
-5
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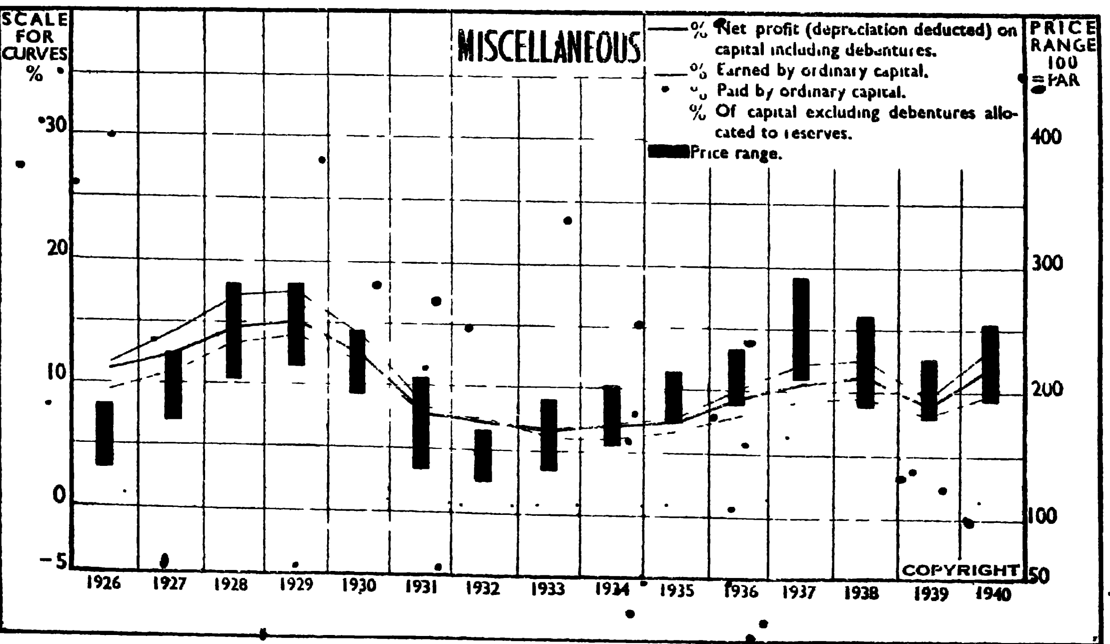

COTTON
% Net profit (depreciation deducted) on capital including debentures.
% Earned by ordinary capital.
% Paid by ordinary capital.
% Of capital excluding debentures allocated to reserves.
Price range.
PRICE RANGE 100 =PAR
400
300
200
100
50
SCALE FOR CURVES %
30
20
10
0
-5
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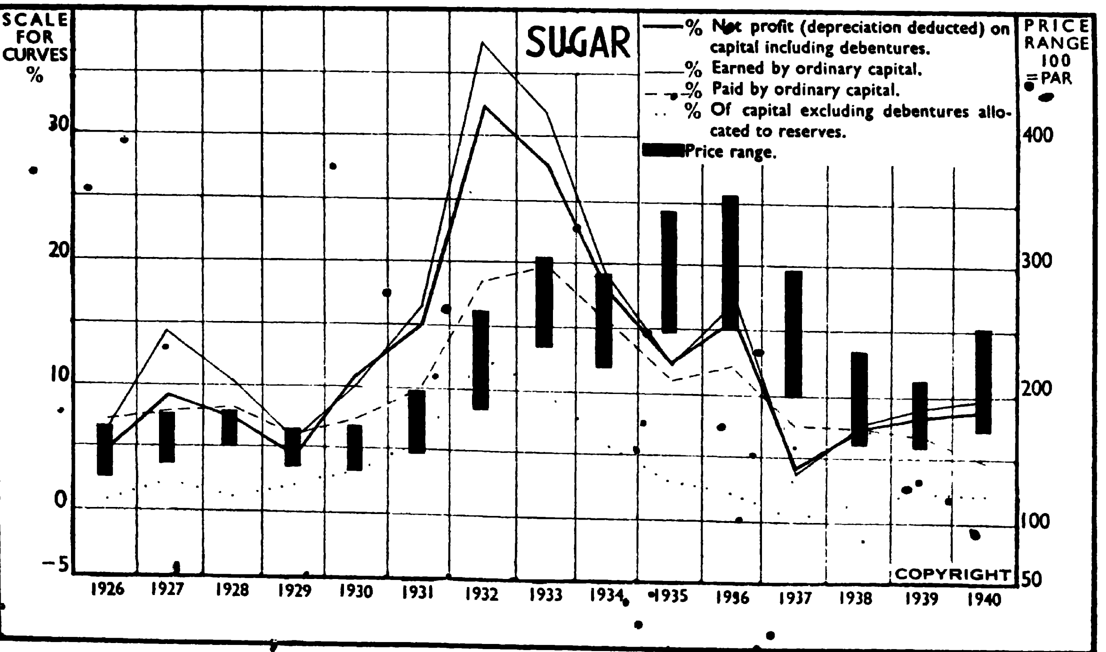

ELECTRICITY
—% Net profit (depreciation deducted) on capital including debentures.
—% Earned by ordinary capital.
—·—% Paid by ordinary capital.
...% Of capital excluding debentures allocated to reserves.
Price range.
SCALE FOR CURVES %
30
20
10
0
−5
PRICE RANGE 100 = PAR
400
300
200
100
50
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1926
1927
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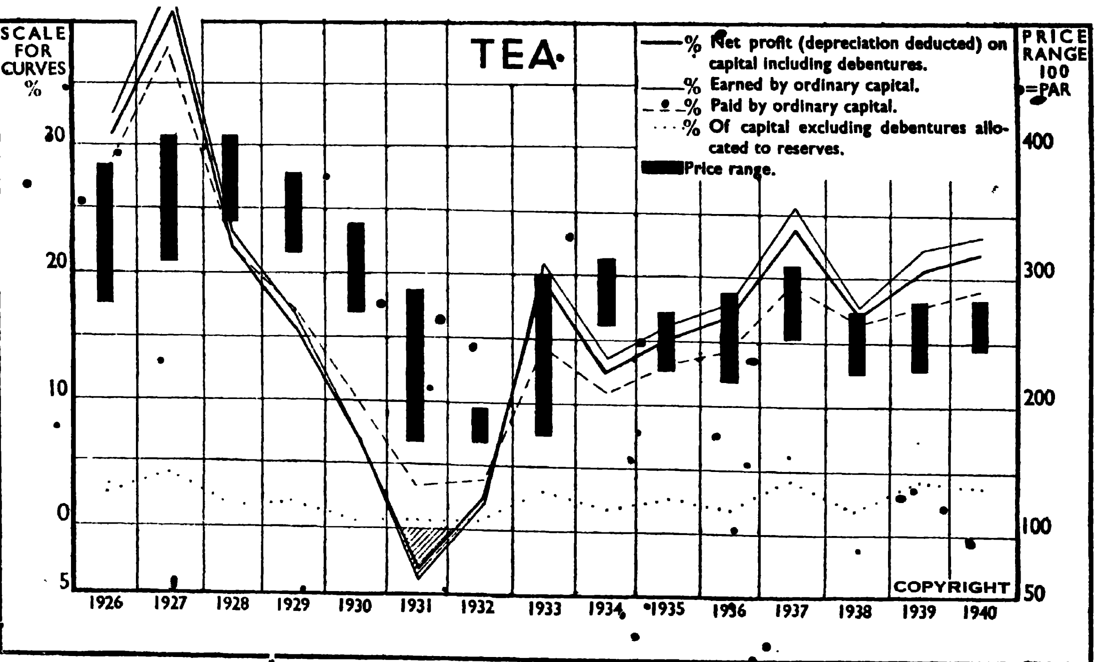


ENGINEERING
—% Net profit (depreciation deducted) on capital including debentures.
—% Earned by ordinary capital.
- -% Paid by ordinary capital.
·% Of capital excluding debentures allocated to reserves.
Price range.
SCALE FOR CURVES %
30
20
10
0
5
PRICE RANGE 100 =PAR
400
300
200
100
50
1926
1927
1928
1929
1930
1931
1932
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1936
1937
1938
1939
1940
COPYRIGHT


JUTE
% Net profit (depreciation deducted) on capital including debentures.
% Earned by ordinary capital.
% Paid by ordinary capital.
% Of capital excluding debentures allocated to reserves.
Price range.
SCALE FOR CURVES %
60
40
20
0
-10
PRICE RANGE 100 = PAR
800
600
400
200
100
1926
1927
1928
1929
1930
1931
1932
1933
1934
1935
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1937
1938
1939
1940
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MISCELLANEOUS
% Net profit (depreciation deducted) on capital including debentures.
% Earned by ordinary capital.
% Paid by ordinary capital.
% Of capital excluding debentures allocated to reserves.
Price range.
SCALE FOR CURVES %
30
20
10
0
-5
PRICE RANGE 100 =PAR
400
300
200
100
50
1926
1927
1928
1929
1930
1931
1932
1933
1934
1935
1936
1937
1938
1939
1940
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SUGAR
% Net profit (depreciation deducted) on capital including debentures.
% Earned by ordinary capital.
% Paid by ordinary capital.
% Of capital excluding debentures allocated to reserves.
Price range.
SCALE FOR CURVES %
30
20
10
0
−5
PRICE RANGE 100 =PAR
400
300
200
100
50
1926
1927
1928
1929
1930
1931
1932
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1934
1935
1936
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1938
1939
1940
COPYRIGHT


TEA
SCALE FOR CURVES %
30
20
10
0
5
PRICE RANGE 100=PAR
400
300
200
100
50
% Net profit (depreciation deducted) on capital including debentures.
% Earned by ordinary capital.
% Paid by ordinary capital.
% Of capital excluding debentures allocated to reserves.
Price range.
1926
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intricacies, many companies have deemed it expedient to create a Taxation Reserve Fund from which to pay the assessed tax when the questions under dispute are settled. Since this tax will have to be paid sooner or later we have considered it as a liability to the Government and deducted the provided amounts from the profits before arriving at the net profit.

The statistics not of all but of most of the companies in India, in each group, have been collected together in order to represent the true position of each group of industry and it is hoped that readers, while going through these pages and even after, will spend a little more than passing time on the charts presented, to compare critically one group with another and find out which group or groups offer the best medium for investment.

Invariably, the conclusion will be that the Electricity and Bank shares offer the best security, for, as compared with other industries, the earnings, distributions and consequently prices do not fluctuate widely.

Unfortunately, it has not been possible to give illustrative charts of the Insurance Companies, for, there being only a few quoted on the stock exchanges—most of them being of recent origin—the illustration would not be

substantiated in the desired manner. But it must be admitted that Insurance Companies are as good as Banks, and therefore their shares stand on an equal footing, if not better than Bank shares, because India being under-insured and in view of the vigorous campaign that is now afoot, there is a wide scope for these shares.

It has also not been possible to set out statistics of steel, mining, chemical, cement, etc., industries for the same reason as above, and companies in each of these groups being only a few, those interested will get the necessary information on reference to reference books such as the Investor's India Year-Book, compiled by Messrs. Place, Siddons & Gough, Calcutta, and the Investors' Encyclopædia (with which is incorporated) "The Southern India Investor," by Messrs. Kothari & Sons, Madras.

There are many types of ordinary shares. All are liable to be affected by depression or by unfavourable rumours, but some very severely, and it is not difficult to distinguish one class from another. Take for example Bank and Tea shares. In the following table are given two types of figures, one showing the percentage rise or fall over the average price of 1928 and the other giving percentage dividends paid. These figures are based on the averages of highest

and lowest prices touched during the respective years.

	1929	1930	1931	1932	1933	1934
Teas						
Rise or fall % ..	—7·0	—18·9	—38·6	—51·3	—36·7	—22·9
Dividend % ..	17·35	9·82	3·36	3·73	14·53	11·0
Banks						
Rise or fall % ..	—2·7	—11·1	—25·9	—24·4	—14·5	+3·1
Dividend % ..	12·9	12·9	10·5	10·63	10·52	10·75

An investor who had bought tea shares in the year 1928 and held them until the great depression of 1931, would have found his investments depreciated during this period by over 50 per cent. and if he had been forced by circumstances to realize his holdings then, it is but natural that he would have lost about 50 per cent. of his capital. Had he held them until 1934 by which time the markets had practically recovered, his holdings would still be depreciated by about 23 per cent. But see how Bank shares behaved. The same investor buying Bank shares in the year 1928 would have found his shares depreciated during the acute period of depression by about 26 per cent. but in 1934 he would have been relieved to see them not only fully recovered but also appreciated by 3 per cent.

Not only this but, when the average yield for these six years is taken into consideration,

we also find that Tea shares have yielded only 2.7 per cent. per annum, yet, depreciated by 22.9 per cent; whilst Bank shares have, in addition to giving a fair yield of 4.3 per cent. per annum, appreciated by 3.1 per cent.

Shares of reliable Banks, Insurance and Public Utility like Electricity Supply companies are the best for investment and although they are prone to depression, they offer greater security than any other class of ordinary shares as will be seen from these charts. They have limited scope for immediate capital appreciation because, unlike industrials, they are not speculative and even those who invest with the object of lock-up investment seldom go unrewarded.

There are shares of other miscellaneous companies also that are good for investment. To name only a few: Bengal Chemical & Pharmaceutical Works, Indian Radio & Cable Communication Co., Ltd., Associated Cement Companies, Calcutta Steam Navigation Co., Ltd., etc., and investors who keep a watch over such companies usually do well in the long run. They specialize in certain business and develop it to such an extent as to earn uninterrupted profits.

The shares of other groups also offer a good home for capital provided the investments are evenly or proportionately distributed in

accordance with individual requirements. It is always advisable, before embarking upon investments of this nature, to study in general, the past and present conditions of the particular industry one is interested in, keeping in mind the future outlook, and it is only then that selections should be made. Almost always, the market leaders are preferable for the man of ordinary intelligence when market conditions are either normal or abnormal for, although they afford lesser yield, they also afford equal chance for capital appreciation, and give better security to capital.

On account of the changing times it is not possible to discuss here the position of various industries from the investor's point of view, and even if this were possible it would require several volumes of the size of this book to deal comprehensively with various industries. Each industry has its own factors which guide its destiny. Output, offtake, raw material prices, internal and external markets, competition, tariffs, normal and abnormal demands, scientific and mechanical inventions and progress, past results and future prospects are factors worth consideration of an investor, but he has neither the time nor easy access to this information. It would therefore be best to stick to shares of the soundest companies bought in the depressed market and closely follow them with a view

to snatching profits whenever they occur due to speculative rises, or be satisfied with the moderate yield they give.

Conditions during a slump are different. Everything, no matter whether good or bad, is affected and those who enter the market during this period may buy anything, but not blindly, with the ultimate hope of appreciation. The best shares during such a period are Engineering, Tea and Rubber, for, they usually lead during boom and slump. This action can only be taken if fresh capital is available for investment, otherwise conversion of one type of shares into these highly speculative shares may offset the balance of the investment portfolio and land the investor into difficulties.

We said somewhere that Bank, Insurance and Public Utility shares are good for lock-up investments. Well, what is a lock-up investment? We know of many who, with the intention of holding shares as investments for a pretty long time, buy anything that is recommended to them, regardless of whether it has long view prospects or not, and ultimately repent if, in due course, their holdings have not advanced or maintained the rise which had taken place after the purchase was made. Any and everything is bad enough for lock-up investment. It needs no tips but foresight. Lock-up invest-

ment is buying and holding shares for a long period, say, 5 to 10 years or more, with the object of greater profit—increasing one's capital by maximum possible appreciation.

We can see that Banks, Insurance and Public Utility companies have slowly but steadily come up and continue advancing. There are many Banks and Insurance companies that have built up strong credit structures and name. They are worth watching. The business of Public Utility concerns is a sort of a monopolistic one and therefore there need not be any fear of competition. India is forging ahead industrially. There are, therefore, great possibilities for these companies, and those catering for the needs of growing cities and industrial towns should receive greater attention from investors. The greatest advantage these shares enjoy is that the earnings of Electricity concerns are not liable to setbacks. On the contrary, they tend to rise. The chart on electricity shares does not very well endorse this opinion. The reason is that many companies of recent birth not having had enough time to establish themselves, retard the attractive qualities of the chart.

Then come new and promising companies such as the Steel Corporation of Bengal and the Tata Chemicals. It is worth while taking a risk in such companies for lock-up investments. There are old companies also which, for some

reason or other, might have fallen on bad times, but which might still hold possibilities of recovery, and if their shares have been heavily depreciated so as to fall below the intrinsic value, then they also warrant such an investment. Hopeless companies also at times, yield sweet fruit when their capital is reorganized.

The intrinsic, or true value of an ordinary share can roughly be judged by the earning power of a company, its dividend policy, reserves, financial position and last, but not least, the yield. The value of an ordinary share is not stationary but varies as the deciding qualities of a share change so that a shrewd investor who is sensitive to these changing factors can manipulate his holdings to advantage. The par value or the price paid for ordinary shares, therefore, has nothing to do with the market value. The par value indicates nothing more than the original value of the share. The purchase price only serves to calculate profit or loss on investments and nothing more.

It is not always difficult to foresee depreciation of a share if it is due to direct causes such as bad business. If over years, there is a tendency for the earnings to fall due to, say, overproduction, if inadequate sums are allocated to depreciation, if reserves are drawn upon to maintain dividends, if stocks are increasing and if the carry forward balance is thinned, then it is a

sure sign of a crack and the investor had better leave this share alone.

When planning for a long term investment, *i.e.*, for about 10 years ahead, the industrial and engineering shares offer the best medium provided the time of depression is selected for buying, but if investment is made during a boom period then the results will very likely be the reverse, because these two classes of shares are the first to suffer during a slump and lead during a boom. But the chances for such opportune investment are so rare that we always exhaust our patience long before the opportunity occurs. In the circumstances, the best procedure is not to approach the market in times other than of a slump when you wish to buy ordinary shares for long term investment, unless, of course, you are very well acquainted with the investment technique.

This does not strictly apply to shares of progressive companies like Electricity, Bank and Insurance, because as we have seen before, these companies do not get affected by the periods to the same extent as Engineering and other companies. But even here, one must go cautiously and, if possible, postpone the long-term investment programme until such time as an opportunity occurs, by keeping the available funds in high grade preference shares, debentures or securities.

Experience shows that many investors approach investment in ordinary shares with a wrong notion. They believe that if a company has earned good profits for some years, it will continue doing so. Therefore, when once they invest, they do not bother to survey their holdings from time to time, giving due regard to the position of the industry in which their capital is put. This absurd principle badly punctures the investment portfolio.

Take for example the Jute industry. All went well with this industry until 1928-29. By this time the industry had expanded to such an extent as to have its production far exceed the offtake. This together with the internal dissensions and cheaper substitutes abroad, had hit the industry before the outbreak of war so hard that reserves had been considerably dissipated and we can well imagine what would have happened if the present war had not come to its rescue. Further reference may be made to the respective chart on page 81 which will speak volumes.

With the steady decline in earnings, came the disaster of many investors. who had clung to large ordinary holdings, due, perhaps, to their being unable to take warning of the impending danger at later stages or being unable to part with their holdings at a great loss.

The size of a company is not necessarily the important point to consider while selecting ordinary shares for investment. There are quite a good number of small or moderately sized companies that do wonderfully well and these are the companies that should receive greater attention from investors. We have begun to realize that these latter companies are as good as, if not better than, huge concerns whose ramifications are often tangled, half-hidden and obscure, so that it requires greater skill and knowledge to form a clear opinion of their exact financial position. Such companies should, therefore, be left alone by investors with limited knowledge.

We have E. D. Sassoon United Mills Ltd., with capital, issued and subscribed, of Rs.2½ crores whose average working for the last 10 years shows a loss of about Rs.5,24,000 per year. On the other side we have a moderately sized company of the same group. The Vishnu Cotton Mills Ltd. The subscribed capital of this company is Rs.24 lakhs and the average profit for the last 10 years amounts to Rs.2,73,000.

From this it must not be inferred that all big concerns are bad and smaller ones good. Scrutiny of balance sheet in the manner suggested in the chapters on balance sheets will decide whether the company under investigation is good or bad for investment.

CHAPTER VIII

Investment in Preference Shares

Much of what we said in connection with ordinary shares applies to preference shares also as these shares, although they carry greater security, are not absolutely immune from risk. With the exception of only a few these shares have generally no participating rights, protection of redemption date or other special advantages but they all carry the right to a fixed rate of dividend, either cumulative or non-cumulative, from the net profits after paying debenture interest, if there be any debentures, but before paying dividend to ordinary shareholders.

Cumulative shares are better than non-cumulative preference shares because if a company, on account of bad business is unable to pay a dividend then it has to make good the arrears of dividend from the profits of succeeding years. Not so with non-cumulative preference shares. They have to remain quiet if the company is unable to pay in any year either part or full dividend.

There are exceptions, however, to every rule. In 1928 when the capital of the Craig Jute Mills Ltd., was reorganized on account of its very bad financial position, the rate of dividend

on its cumulative preference shares was raised to 9 per cent. per annum and all rights to the dividends in arrears from 1922 to 1928 were cancelled. The financial position not having been improved by 1940, the capital was again reconstructed in that year. In addition to reducing the nominal value of preference shares from Rs.100 to Rs.50, the rate of dividend on them was also reduced from 9 per cent. to 5 per cent. per annum and all rights to the arrears of cumulative dividends from 1929 to 1940 were again cancelled. When a company's finances are such, the preferential shareholders have necessarily to suffer with the ordinary shareholders.

Unlike ordinary shares, in case of winding up, preference shares have priority for repayment of capital after satisfying all trade creditors and debenture holders. Not much importance may be attached to this point as no good company is ever liquidated solely for the purpose of dividing its assets unless the Government or Municipality decide to take it over, in which event ordinary shares may receive more than the capital originally invested with no hope of preference shareholders receiving anything more than their originally subscribed capital, or seldom any nominal premium as provided in the Articles of Association of the company. But if a company is dissolved for reasons of continually bad business then it is hardly necessary to say that

preference shares, in anticipation of receiving less out of the dissipated assets than is due, will depreciate considerably in advance.

Preference shares can roughly be divided into two broad divisions. One class is of shares that are covered by earnings many times more than the actual amount required to meet their dividend. Such shares are high-grade but low-yielding, and the yield does not generally differ substantially from what is got on long dated or perpetual Government or Provincial loans, etc., or some undated debentures. The other class of shares is of those which have a thin cover of dividend and which do not receive dividends regularly. The capital invested in such shares is less secure though the yield is more.

For the purpose of illustration, Allahabad Bank and Tata Iron & Steel First Preference shares can be put in the first class. Their requirements are so very well covered by profits that we can have no doubt as to their attractiveness for many more years to come. On the other hand we have low-class shares such as those of Associated Hotels of India Ltd., and Spencer & Co., Ltd.,—" B " preference shares —whose earnings have decreased to such an extent as hardly to cover the requirements of preference shareholders. Both are cumulative and pay dividend regularly but despite this fact

they do not take any strength and rise above their par value. They are even considered to be inferior to an average ordinary share. There is only one reason for this. The fact that earnings of these companies for the last few years have been very low and with no hope of substantial recovery in the immediate future, in conjunction with their poor financial position, has kept the shares depressed and their price movement shows that they hardly respond to market activity.

The only perceptible difference between the preference and ordinary shares when a company's earnings begin to decline is that the preference shares depreciate more slowly than ordinary shares so that the preference shareholder has enough time to consider the only advisable action, which is to sell as quickly as possible. But ordinary shares being very sensitive are like shadows of coming events. They drop at the mere possibility of a company's unsatisfactory trading.

While selecting a preference share, the first thing to consider is whether the company's net earnings are such as to exceed by much the amount required to pay preference dividend, and the more thickly this dividend amount is covered the stronger and more attractive the preference share becomes. This can be judged from the balance sheet, a minute scrutiny of

which is essential. The second point is to select a good share at the lowest possible price so as to obtain maximum yield possible which should be well below that given by long dated and perpetual Government securities, Provincial loans or debentures. Otherwise, it is not worth while investing in such a share, because in times of dear money conditions this share will depreciate irrespective of the first class security it offers, so as to fall into line with the securities of its nature for reasons we shall presently see.

As in the case of ordinary shares, the size of a company is not necessarily a good point to consider when buying preference shares. There are many companies that are heavily capitalized giving only a thin cover to the preference dividend requirements as against some of the smaller companies, the preference shares of which offer as much security as that offered by gilt-edged securities.

Another point to consider when examining a preference share is the arrangement of capital as discussed on page 62. The bigger the proportion is of preference capital, the less is the security the preference shares offer in the case where a company does not do well.

The argument of selection of preference shares necessitates touching upon a point which we have already dealt with in Chapters VI and

VII, "Investment in Ordinary and Deferred Shares", because it is vital, and for the purpose of ready reference we will briefly go over it again. While selecting a preference share one must always have in mind the nature of the business the particular company is engaged in and must consider if its profits are subject to wide fluctuations. All the industrial groups and plantations, as will be seen from the charts, were affected considerably during the slump of 1931, giving hardly any cover to the preference dividend requirements. This involves danger of some of the dividends falling into arrears. This has happened before. The investor should, therefore, look out for financially sound companies of such groups unless he approaches investments when money conditions are dear, during a slump or at a time when markets are just recovering from one. This does not, of course, strictly apply to Bank, Insurance and Public Utility shares, particularly the last, for, on account of the possibility of steadily rising profits and consequent better cover, they become more attractive.

Unlike ordinary shares, preference shares are unable to participate in the prosperity of their company, whatever the magnitude of profits may be, because they generally carry the right to a fixed dividend only; unless, as we said before, they have participating rights. Another point

where ordinary shares score over preference sharer is in times of inflation—when money buys less—because companies being in a position to ask higher price for their goods can earn unusually large profits and distribute them proportionately to the ordinary shareholders; whereas the preference shareholders have to remain in an unenviable position and buy less with the income produced by their shares.

One more point against preference shares, which has been referred to but not discussed so far, is that these shares are vulnerable to changing monetary conditions. There are only a very few preference shares which are redeemable, but all the rest are irredeemable and therefore they have to adjust themselves to conditions necessitated by the change in money values. That is, when money is dear and consequently borrowing rate high, the preference shares, and medium and long-dated securities depreciate. Conversely, when money is cheap all fixed-income scrips appreciate. In other words, all fixed-interest shares and securities with the exception of those bearing short-date depreciate or appreciate as circumstances dictate. So the yield given by preference shares tends to rise or fall, as the case may be, in order to have relation to the borrowing rate, this depending upon the soundness of the scrip. In order to avoid repetition, we will endeavour to explain more fully in Chapter X

—"Investment in Securities"—the reason why fixed-interest preference shares or securities are influenced by monetary conditions as the question has more bearing on securities.

From this it will be inferred that it is not advisable to buy preference shares when money is very cheap, particularly for those that may have the occasion of drawing upon such investments any time. The reason for this will be better understood by applying simple mathematics.

Rs. 100 5% Pref. share to yield 4% should stand at Rs. 125.

Rs. 100 5% Pref. share to yield 4½% should stand at Rs. 111.

The above proportions have been drawn upon the supposition that money conditions at the time of buying are cheap and at the time of selling are not extremely dear.

Supposing that 4 per cent. is the yield afforded by preference shares at the time of buying, the investor will have to pay for every good 5 per cent. 100-rupee share, Rs.125. If after a few years, let us say seven, when money becomes a little dear and preference shares on an average yield 4½ per cent., he is required to liquidate his preference holdings, these will realize Rs.111 for every Rs.125 invested seven years before,

because the average yield on preference shares being 4½ per cent., the shares will have declined to Rs.111. This means a capital loss of Rs.14 which investors very often ignore because they are satisfied with the regular yield of 4 per cent. per annum obtained for full seven years. Or even if they do remember the price originally paid, they ascribe the loss to their stars and console themselves by entertaining the thought that 'it is not only they but their neighbours too that' have met with the same fate.

If, in reality, we go to see what actually our investments have yielded us, we get 2.4 per cent. and not 4 per cent. as originally calculated because the income of Rs.5 per share multiplied by 7 years gives us the total income of Rs.35 per share and after deducting the capital loss of Rs.14 we get in hand Rs.21 (on every Rs.125 invested) for the seven years, which works out at 2.4 per cent. per annum on the money invested.

On the other hand, had the money been invested in short-dated Government, Provincial or Municipal loans, preference being given to those bearing a low rate of interest and consequently available at or below par, our investments would have eventually given us at least 2½ per cent. net yield and perhaps a slight capital appreciation.

Even had the supposed investor not had the occasion of liquidating at this stage and was well in a position to ignore the monetary conditions, it would still have paid him to first keep his money in short-dated loans and then switch over to long-dated loans or preference shares, for, he would now get for Rs.111 a share for which he had to pay Rs.125 seven years ago. What is more, the yield on this price would work out to 4½ per cent. as opposed to the running yield of 4 per cent. obtained by the first procedure, not to speak of the possibility of capital appreciation in the event of money again becoming cheap or of the check on greater capital depreciation in the event of money continuing to become dearer.

We have considered one side of the question. But, had money become cheaper after seven years, what then? First and foremost, there can hardly be any possibility of money becoming cheaper than we have considered above. That is to say, the rate at which Government can raise loans is at 2½ per cent. interest, and the Government of India do not appear to have raised a loan at anything below 2½ per cent. interest. Even if the borrowing rate did fall, the preference shares would have appreciated and so also the short-dated loans, though slightly, keeping the basis of our argument unaltered.

This argument should dismiss the impression many investors have that it is always the ordinary shares that depreciate and not first class preference shares.

Admittedly, it is impossible to wait for depression or dear money conditions which recur at long intervals, in order to invest in preference shares, but it would be advisable for investors who have insufficient knowledge or experience of investments and who do not rely upon investment income alone to avoid investments in preference shares that are low-yielding and if good preference shares are not available to give a satisfactory yield, to place that portion of capital which is required to be put in preference shares in short-dated Government or Provincial loans and even in ordinary shares of companies that have future prospects, until such time as suitable opportunity occurs.

Many are of the opinion that preference shares always are, and by far, better shares than any class of ordinaries and this misconception was carried to the extreme at the beginning of the year 1941 when reverses on the war front had instilled temporary fear into the heart of everybody, investors heading all. During this period there was a craze for converting capital into preference shares just as there was a mania for hoarding precious metals including coins. Most

of the good preference shares were heavily bought as a result of which prices went up and the yields down : down to such an extent as not to leave an appreciable difference between their yields and those afforded by long-dated Government and Provincial loans. There is a limit for good preference shares up to which they can be bought for satisfactory yield ; beyond this they lose attractiveness and become a bad investment. If the same money is invested in good class ordinary shares instead, results can be far better.

It is always advisable not to subscribe for preference shares of a new flotation, whatever the rate of dividend may be, unless it has been floated under good auspices such as the Alkali and Chemical Corporation of India Ltd., where dividend is guaranteed for five years by the well-known parent company, the Imperial Chemical Industries (India) Ltd., and which carry the right to conversion into ordinary shares. The preference shares of Steel Corporation of Bengal Ltd. also offered security from the outset in view of the provision made for them to receive 4 per cent. dividend out of capital.

Opinion regarding the mode of investment in preference shares when money is very cheap, is divided. One school of thought believes that when money is very cheap preference shares should be preferred to Government securities

and debentures, because the preference shares are higher-yielding as compared with gilt-edged securities. When money is very cheap preference shares also rise proportionately and comparatively, yield less. It is the firm conviction of the author, therefore, that in times of cheap money, the capital intended for preference shares should generally be retained in short-dated loans or debentures at the sacrifice of a small difference in yields if preference shares are not available to yield convincingly more than the Government securities, by those who have not developed the faculty of following world events and who invariably get caught napping. In such times preference shares are advisable only if we can manage our own investments actively and independently; otherwise, first-class Electricity, Bank and Insurance ordinary shares will be better. The trouble with us is that when we are on one side of the trade cycle we never think of the other. An investor can be excused for neglecting this vital factor only if his planning is for a few years, say 3 to 5; otherwise not.

CHAPTER IX

Investment in Debentures

In India, the debenture capital is small, most of which is in the hands of Banks and Insurance, and other companies. Only a fraction of it is quoted on the Indian markets and deals can be put through only by means of negotiations. Presumably because of this there is little interest on the market from investors in this scrip, however good it may be. As interest in investment expands, however, there ought to be increased support from investors for debentures and for this reason we will deal with the important points that have relation to investment, leaving aside others that lend no substantial aid to investors.

A debenture is a sort of loan given by the investing public or by an institution or by one person to a concern that is in need of it, bearing a fixed rate of interest, generally on the security of its assets, be they fixed or floating.

Fixed assets are those that are immovable such as land, buildings, property, plant and machinery, and circulating and liquid assets such as book debts, cash, investments, stocks, work in progress, etc., as we have seen in the chapter on balance sheets, can be put under the category

of Floating Assets. These floating assets are not very reliable to the debenture holder because they keep on fluctuating from day to day. They can be disposed of by the company because there cannot be a fixed charge on them but only a floating one. Floating assets may be wasted and therefore, they are not a stable security, particularly in the case of concerns which are in difficulties.

The liability on the partly paid ordinary or preference shares, although it is a real risk to the investor holding such shares, is a safeguard to the debenture holders who in the event of the company's assets not satisfying their requirements, can call for the unpaid capital provided such a capital exists and there is a charge over it.

It is imperative, therefore, that the investor before going in for debenture must inspect the Debenture Deed and see how and on what assets the debenture has been secured, and if he has neither the time for nor a knowledge of this, then he had better leave it alone unless he is fully satisfied that the debenture has been issued by a progressive concern for the purpose of expansion of its business, success for which is assured.

Broadly speaking, there are two types of debentures, one redeemable and the other irredeemable. The latter class of debentures is

rate and is raised by established concerns whose financial position is above all suspicion. Redeemable debentures, as in the case of dated Government loans, give protection to capital in that they are not susceptible to depreciation on account of depression or of monetary conditions changing, as they approach maturity.

These redeemable debentures sometimes hold additional advantages and the right to draw. That is, for the purpose of minimising the debenture burden as and when possible, some Deeds hold the provision that the Sinking Fund or the Amortization Fund, expressly created for the purpose of paying off debentures, may be utilized annually or at longer intervals to draw debentures by means of a ballot to the extent the accumulated amount will permit, and thus, gradually by the date of maturity most of the debentures are redeemed relieving the company of the interest burden.

From the investor's point of view these types of debentures have distinct features of their own and therefore they need clarification. Redeemable debentures may be short or long-dated. These again have distinct advantages which have been discussed in the previous chapter. Irredeemable debentures are more or less like preference shares and need the greatest caution while buying, the reason being that the deben-

ture holders cannot force the company to redeem the loan whatever the financial position of the company may be, provided regular interest is paid and, therefore, if the earnings provide a very thin cover to the debenture interest so as to leave no margin for distribution to preference and ordinary shareholders, then the debentures will depreciate. Depreciation will also take place when money conditions become dear as we have already discussed elsewhere.

When a debenture is redeemable by drawings, purchase should also be carefully considered because if a high premium is paid for a debenture that holds the possibility of redemption by drawing within a few years, then the holder will suffer in the event of his number being drawn and paid at par or at a small premium. Conversely, if such a debenture is bought at a discount then the holder stands a chance of being repaid at par or at a small premium should he be lucky enough to appear in the ballot.

It is said that the debentures of Electricity concerns are the best, but as in the case of other debentures too, it all depends upon the security they offer. In the event of a company catering for an undeveloped town having no possibility to expand owing to other towns in the vicinity having geographical and other advantages, it will in the long run suffer and debenture holders,

should there be any, will in the event of foreclosure hardly get anything if the supply was taken from a power supply company. But though such extreme cases are rare, investors should not ignore the possibilities altogether while considering the purchase of debentures of unknown electricity supply companies. So also with mining companies which on account of the wasting nature of assets do not offer good security to the debenture holders unless the mines have a long life and the debentures are redeemable much before that.

There are other similar industries which solely depend upon some sort of protection or advantages over others, but as long as the debenture is secured on fixed assets which can easily be disposed of when the necessity arises and is well covered, (that is, if the assessed value of the assets at the time the debenture was secured is almost double the amount required to cover debenture liability) and if the past and present earnings cover interest and sinking fund requirements well, then the investor should not much worry as to the nature of the company's business although preference should be given to monopolistic concerns such as Electricity, Tram and Telephone companies, as the tendency of the earnings of such companies is to increase, providing thicker cover to debenture interest and sinking fund requirements.

The debenture holders are entirely on a different footing from ordinary or preference holders. These latter, as we have seen, only depend upon the earnings of a company, whereas debenture holders, who have the right to pounce upon the assets if the interest is not forthcoming regularly, are entitled to no more than the interest due on holdings and the capital lent, with the possibility of this being repaid at a small premium or being sold on the market at a more or less favourable price, it all being dependent upon the soundness of the debenture.

There are exceptions however, and one of the rare advantages the debentures enjoy and to which necessary weight should be attached by the investing public, is the right to conversion into ordinary shares. The Steel Corporation of Bengal Ltd. is a case in point. This concern issued in 1937 £1,000,000 in 4½ per cent. guaranteed registered mortgage convertible debenture, repayable at par in 1967 but subject to be redeemed in whole or in part at 2 per cent. premium on six months' notice after 1st January 1947. The debenture holders are entitled to convert their holdings before January 1947 into fully paid up ordinary shares in the proportion of 40 ordinary shares of Rs.10 each for every £50 debenture. The ordinary shares of Rs.10 each (fully paid up) are at the time of writing quoted at Rs.20 each.

Holders of about a third of debenture capital have, so far, taken advantage of the conversion and those who intend doing so at the present rate will get Rs.800 worth of ordinary shares for every Rs.666 (£50) worth of debenture, thus appreciating their capital by over 20 per cent. in addition to getting Rs.4-8 interest for the period the debentures were held.

The difference this conversion makes at the present stage is impairing the absolute safety of the capital. But as long as there is nothing to suggest that the company's outlook is gloomy and, on the contrary, as there is every possibility of the turnover increasing particularly owing to the war conditions and the reconstruction period following it, there should not be great fear for ordinary shareholders. Besides, this concern, although new, gives debenture holders five more years for conversion during which period the company should be in full production. It is evidently for this reason that about two-thirds of the debenture issue is left in safe position until such time as the ordinary shares advance and offer still better terms for conversion.

It is too early yet to measure in a proper degree the possibilities these debentures hold and it is not becoming in a book of this nature to forecast trends, but it is almost certain that even those who buy now at £120 will be amply re-

warded before 1947 even taking into consideration the possibility of the debentures tending to approach par from the year 1947.

It is the opinion of many that a company issues debentures only when it is in low water. It is not necessarily so. Debentures might be required by a company that is in such an unfortunate position, in which case debentures generally carry a high rate of interest, but they are also required by sound and well established companies that wish to expand their business by the cheapest means.

It is also not clear to some why some companies call debentures when they can raise the required capital by issuing new ordinary shares, even at a handsome premium. This course is followed sometimes but the difficulty arises when the question of payment of dividend comes. Ordinary shares are of a permanent nature and, therefore, they always stand to share the profits, thus minimising the distribution the old ordinary shares would otherwise receive. This may be explained by an example.

If a company's capital is Rs.20,00,000 divided into ordinary shares, the profit earned is 10 per cent. per annum and paid 6¼ per cent., it is doubtful whether a fresh issue of the magnitude of Rs.15,00,000 in ordinary shares will be fully subscribed unless the company's circum-

stances are exceptional. Assuming that it is successfully raised even at a small premium, the chances are that dividend distributions will initially suffer as there is always a tendency, under normal conditions, for the profits of companies having a new ordinary issue to fall, because the new capital employed takes time to earn as much as the old capital. This is evident from the earnings and the behaviour of ordinary shares of companies that have issued new ordinary capital or that have given capital bonuses.

Even if we were to assume that the company's new ordinary capital would from the outset earn as much as that earned by the old, the financial position of the company would remain somewhat unaltered, with a tendency to suffer. Whereas if we were to place 4½ per cent. Debentures in the place of the new ordinary issue, the position would be entirely different. First and foremost, the debentures would save from the outset 1¾ per cent. on the dividends of the new ordinary issue and the difference would be accentuated if the company were in a position of making increased distributions, and taking the increased distribution as 10 per cent. only, the total ordinary capital of Rs.35,00,000 would require a dividend of Rs.3,50,000, whereas the original capital with debentures would, on the same basis, require only Rs.2,67,500, a saving of

Rs.82,500 which, if utilized for dividend on ordinary capital of Rs.20,00,000 would enhance the dividend to over 14 per cent. Alternatively, if this amount of Rs.82,500 is utilized towards the sinking fund, it will strengthen the fund and serve to wipe off the debentures earlier, the Deed providing. Lastly, when the debenture is wiped off, it will be the privilege of ordinary shareholders to share the amount which would otherwise go in paying debenture interest and to enjoy the fruits raised by the debenture capital. The issue of new ordinary capital would, on the other hand, keep the company for ever heavily capitalized with no prospect whatsoever for ordinary shares to score over those that have the backing of cheap debenture capital.

To take a concrete example, we have the Naihati Jute Mills Co., Ltd. The issued and subscribed capital of this company is Rs.17,50,000 divided into Rs.10,00,000 ordinary shares and Rs.7,50,000 7 per cent. taxfree cumulative preference shares. There is also a debenture capital of Rs.12,00,000 in 4½ per cent. taxable bearer bonds issued in 1937. The financial position of the company, taking all things into consideration, is good. The dividend earned by the ordinary shares for the year 1940 was a little over 15½ per cent. and paid 14 per cent. If the debenture capital of Rs.12,00,000 were replaced by ordinary capital, the ordinary shares would

earn for the year 1940, keeping other things equal, 9½ per cent. and on the same ratio of distribution would be paid 8½ per cent. See what a striking difference the substitution of ordinary capital makes!

Whether or not the price to be paid for a debenture is reasonable, is a question that should be considered by the investor alone in accordance with his requirements at the time of investing, because there are several debentures that offer security in varying degrees and the investor would be well advised to compare the yield of the best debenture with that offered by one that is under consideration bearing in mind the fact that the greater the yield, the less the security.

At the time of writing about 3¾ per cent. is the gross yield given by good class debentures, which makes a striking contrast to over 6 per cent. afforded by many unsound debentures. For instance, there is one jute mill in India which has 7 per cent. taxable bearer debentures repayable at par on 31st July 1945. This capital was raised in 1925 when the company was financially embarrassed and, therefore, a high rate of interest had to be paid. The financial position of the company remains unaltered however, and it is problematic how debentures will be satisfied on maturity. The debenture price now is around Rs.102 for Rs.100, yielding roughly 6.9 per cent.

The soundness of the debenture can be judged, as in the case of preference shares, by the earning power of the company and how conservatively the mortgaged assets have been assessed. A mortgage on a concern holding large property is better than that on a mining company in so much as the value of land, particularly situated in a city increases as time passes whereas that of a mine decreases in view of the wasteful nature of its assets. This is a point for the investor to consider before buying but it must be remembered that the purpose of investing in debentures will be defeated if the yield as compared to Government Securities is not substantially high and if redemption terms are overlooked.

Some of the relevant features of debentures have already been dealt with in the last chapter and since most of what is being said in the next applies to debentures also, we wish to avoid repetition here.

CHAPTER X

Investment in Securities

Giving due prominence to securities, we should have started this chapter first followed by those on debentures, preference and ordinary shares, as the securities which offer safety and reliability of income are the best investment that can be obtained. But the public having more interest in ordinary and preference shares, we have treated them first.

By securities, we shall mean Government of India, Provincial Government, Municipality and other allied loans which are raised by the respective authorities for the purpose of national advancement. Not all of them offer equal safety to the investor, primarily because of varying dates of redemption which render them vulnerable to changing monetary conditions. The other factor, although insignificant, that makes them unequal in safety is the variation in the strength between the Government of India finances and those of Provincial Governments and other public bodies such as Municipalities, Port Trusts and Improvement Trusts.

Thus, the rupee loans of the Government of India which are as strong and safe as any existing on earth to-day cannot be compared with the

loans of Provincial Governments or other public bodies which entirely depend upon the ability of the public under their protection, to pay taxes. This is one of the reasons why we see a difference, although small, between the prices of various loans bearing the same redemption date.

Take for comparison two loans bearing the same rate of interest and redemption dates (1) Government of India 3 per cent. 1963-65 loan now quoted at Rs.95, yielding 3.16 per cent. and (2) Calcutta Improvement Trust 3 per cent. 1963-68 loan which is quoted at Rs.90, yielding 3.33 per cent. The difference in price or the yields is not necessarily a pointer to the degree of safety. The aggregate amount of Government of India loans is many times more than that of other loans taken group by group. For this reason naturally, there is more interest displayed amongst the investors in Government of India loans which can change hands very quickly than in others which on account of the small volume, sometimes require a little negotiation before the deal is put through. This partly keeps them below the Government loans.

In previous pages, while discussing debentures, we said that there were redeemable and irredeemable debentures. Here again, there are redeemable and irredeemable loans, sometimes

called terminable and non-terminable respectively. Terminable loans can again be divided into three classes, *viz.*, short-dated, medium-dated and long-dated. Those having a currency or a life of under 10 years can be classed as short-dated and others having between 10 and 20 years' currency may be classed as medium-dated. The loans having upwards of 20 years to run come under the category of long-dated loans.

So, we have in all four types of loans, (1) Short-dated, (2) medium-dated, (3) long-dated and (4) irredeemable. This last type can, at the option of the Government, be redeemed after giving due notice to the public, but this does not happen unless the Government is in a position to borrow at a cheaper rate of interest than that borne by the existing non-terminable loans, (save of course, if the Government wants to wipe it off).

Governments, whenever in a position to do so, take advantage of cheap money conditions ruling in the market and borrow on non-terminable terms. Long term borrowing is also resorted to when monetary conditions are such, but when money is dear it is natural for them to offer a short term to the public knowing full well that sooner or later, when money becomes cheap, they will be in a position to replace the same by cheaper loans. This, however, was not strictly

so during the period following the last war during which period, apart from financial instability, there was need of money for reconstruction, with the result that the borrowers had to go out of their way to attract public funds.

In the previous chapters, we have seen to a certain extent in what way the difference between dated and undated loans affects investors and here again we will repeat just what is necessary. The only fear regarding investment in irredeemable and long-dated loans is of being caught at the highest price which is invariably reached when money is cheap.

The fixed-interest securities when the borrowing rate is low, rise to yield as much as the borrowing rate and, conversely, fall when money is dear in order for the yield to be in line with the higher borrowing rate. Those that suffer most are the non-terminable loans which offer no protection of redemption date to the investing public. Next in order come long-dated and medium-dated securities. Short-dated loans are affected but slightly, and as they near maturity, they tend to approach par or the redemption value as the case may be, irrespective of the money or market trend.

It follows, therefore, that if an investor buys a long-dated or irredeemable loan when money is cheap with the purpose of long-term

investment, he will pay the highest price, which in other words means that he will get the lowest yield on his investments throughout the period he holds the securities whatever the monetary conditions may be during that period. Whereas, for the same purpose if he first buys short-dated loans and then converts them into long-dated or undated issues when money becomes dear, he will get the best results.

To take a concrete example, we have the $3\frac{1}{2}$ per cent. 1947-50 taxable Government of India loan which at the present price of Rs.$103\frac{1}{4}$ yields 2.27 per cent. net on redemption, assuming that the loan will be redeemed in 1947. The irredeemable $3\frac{1}{2}$ per cent. Government Paper which is now quoted at Rs.96 yields 2.89 per cent. net. The difference between the two yields is, therefore, .62 per cent. or roughly Rs.0-10-0.

The long-term investor who invests in Government Paper now for the sake of Rs.0-10-0 per Rs.100 extra yield and sticks to it during this entire period, should not get surprised if he finds himself with the shadow, with the substance gone past him. For the history of fixed-dated non-terminable and long-dated loans has taught us that however sound a security may be, it cannot stand against the influences exerted by changing monetary conditions or depression.

If, under the existing circumstances we were to forecast the trend of non-terminable loans some years ahead and if our imagination entertained the thought that the 3½ per cent. Government Paper which now stands at Rs.96 would drop to about half this price, we would ridicule our own thought which appears to be an impossibility. Yet many of us remember,—some bitterly, for, their wounds have not yet healed—that only 10 years ago, *i.e.*, in 1931, when the international credit structure had been shaken from the very root by the great slump, this Paper had dropped to Rs.51.

When we know that through mysterious circumstances booms and slumps recur every few years, though not with the same severity, and that the monetary conditions change, can we ignore these possibilities altogether when planning for a long time ahead, unless we are capable of manipulating our investments with due care and attention ?

Now coming back to the investor who gave preference to the Paper for the sake of Rs.0-10-0 extra yield, we can well see how this small difference can be offset to disadvantage by wide fluctuations occasioned by the change in money values. Yet there are many who overlook the possibility of depreciation in securities provided they are confident that they will get back their

capital intact after giving the estimated yield regularly. This recalls to mind a case the writer had the occasion to handle not long ago. Some Trustees had in hand about 8½ lakhs worth of 5 per cent. 1945-55 tax-free loan which they wished to convert into other securities, because it is anticipated that this loan will be repaid on the earliest redemption date. Another reason why they wanted conversion was that the income produced by the present investment fell short by a few rupees of meeting their expenditure. The Trustees wanted conversion into Government of India securities only and were strongly inclined towards Government Paper which yielded most as compared with other Government securities, but even such income would not offset the deficiency. Another and the most important reason for the inclination towards Paper was that they wanted some investment that did not necessitate conversion for at least 50 years thereby saving the trouble involved in doing so, for which they had great distaste. Mind you, these people with the responsibility of Trustees did not want securities that involved selling on maturity and reinvesting the sale proceeds, just to save themselves the insignificant labour involved in doing this.

In fifty years there can obviously be about four good opportunities for investment at low prices and as there was nothing that could be

done to meet the requirements of the Trustees, they were advised either to retain the money in 5 per cent. tax-free loan until maturity or convert it into 3½ per cent. taxable 1947-50 which yielded a shade better, and to convert all the available resources into the heavily depreciated long-dated or irredeemable securities when the unfortunate depression made its visitation. They were also advised if a suitable opportunity did not occur during the period of 5 to 7 years, to continue keeping the funds in short-dated securities, until such time as a suitable opportunity came. This would render the funds depreciation-proof and make available undepreciated securities for conversion into heavily depreciated ones.

What would happen otherwise if a dormant policy were pursued is that the Paper, bought at almost the top price with less than 3 per cent. yield would have had to be held in the basket throughout the anticipated depressions as spoilt eggs, while fresh capital at those periods would fetch 5 per cent. and more with the certainty of capital appreciation. This is not impossible. It has happened before.

To press this point a little further we will see how this works by a simple example, by supposing that an investor with Rs.10,000 to invest pursues an inactive policy, *i.e.*, does not alter an investment once made until the expiry

of the planned term which we shall take as 50 years to line up with the foregoing example. Again, we will compare the results thus obtained with those given by the recommended planning.

For the purpose of argument we will take 3½ per cent. Government Paper because it is irredeemable; and 3½ per cent. 1947-50 loan as it is short-dated—or any short-dated loan will do. The 3½ per cent. Paper is now quoted at Rs.96 yielding 3.65 per cent. and 3½ per cent. 1947-50 loan at Rs.103¼ which yields 3 per cent. taking into account the latest redemption date. Both the yields are gross.

Before proceeding, we will simply quote formulas and then proceed to explain them in detail.

Proposed investment:

(1) $\frac{3.65 \times 10{,}000}{100}$ = Rs. 365 × $\frac{50}{}$ years = Rs. 18,250 total income for 50 years.

Recommended investment:

(2) $\frac{3 \times 10{,}000}{100}$ Rs. 300 × 9 ,, = Rs. 2,700

(3) $\frac{3 \times 10{,}000}{100}$ = Rs. 300 × 5 ,, = Rs. 1,500

(4) $\frac{5 \times 10{,}000}{}$ = Rs. 500 × $\frac{36}{50}$,, = Rs. 18,000 = Rs. 22,200 do.

In item (1) we have multiplied the yield per cent. on the 3½ per cent. Government Paper by the capital of Rs.10,000 which gives the total

income of Rs.365 per annum. This has again been multiplied by 50 in order to arrive at the total income obtained over the total assumed period of 50 years when the policy pursued is inactive or dormant.

In item (2) we have taken the yield per cent. on 3½ per cent. 1947-50 loan, a short-dated loan being our recommendation, because we are experiencing cheap monetary conditions. The total yield per annum on the capital is Rs.300, which is multiplied by 9 years, taking the longest date as the date on which this loan will be repaid.

Items (3) and (4) are based on supposition.

In item (3), 9 years hence (*i.e.*, in 1950), the 3½ per cent. 1947-50 loan when repaid, will necessitate reinvestment. We will suppose that money conditions at this stage are tending to become slightly dear but still 3 per cent. is the yield that can be obtained on short-dated loans. So investment is again made in a short-dated loan, say in 4½ per cent. 1955-60 which at this time (1950) will have only a few years' currency.

But suppose, after 5 years from 1950, or 14 years from 1941, there occurs a slump or money becomes dear, depreciating fixed-income securities. So, it has been necessary in item (4) to convert the short-dated loan from item (3) with no loss of capital (because it will have

approached maturity) into Government Paper which at this time yields, say, 5 per cent. (For non-terminable loans to yield 5 per cent., the short-term borrowing rate of Government should be about 4½ per cent. This is very likely. We had worse conditions before. Twenty years ago, short-term Government of India loans required 6 per cent. tax-free interest to attract public funds. It again happened during the severe slump of 1931). So, for the balance of 36 years the investment is retained in Government Paper which at the time of investment yielded 5 per cent. as opposed to 3.65 per cent. now obtained. This fetches Rs.500 per annum and Rs.18,000 for 36 years.

Therefore, the Government Paper if bought to-day will fetch Rs.18,250 in 50 years, whereas manipulation in the way suggested above will give a total income for the next 50 years of roughly Rs.22,200 which is about Rs.3,900 better even after deducting brokerage and other incidental charges involved in conversion. Not only this. When the short-dated loans were converted into the Paper while the yield was 5 per cent. this would have been available at Rs.70 (to yield 5 per cent.). If, therefore, at the end of 50 years the monetary conditions happened to be as they are to-day, then the Paper would appreciate to about Rs.96, meaning an appreciation of 37 per cent! If, on the other

hand, the conditions remained dear, the Paper, since it was bought at Rs.70 would not much depreciate and would give back almost the full value, whereas in the first case, the Paper bought at Rs.96, would, at the end of the fiftieth year, be depreciated by over 37 per cent.!

In discussing the above possibilities we have taken into account only one chance in 50 years but actually there ought to be more than one, and the above results can accordingly be multiplied to obtain a fair picture of what can happen if investments are made in the way the Trustees would prefer, or how capital can be multiplied in the scientific way.

But what would happen if money were to go still cheaper? We have already said that we are experiencing cheap monetary conditions and there is hardly any possibility of these being accentuated. Even if this did happen to a small degree, our plans would in no way suffer. The Paper, due to speculative activity during the boom of 1936, had touched Rs.101 at the highest but it had also dropped to Rs.51 in 1931. As there is more chance now for money to become dear, why risk funds in long-dated issues that give unsatisfactory yield?

To sum up this point which, we think, we have discussed at sufficient length, we will say that it is always advisable for all, while buying

when money is cheap, to invest in short-dated loans and to convert into long-dated or non-terminable issues when money conditions change; and conversely, when money is dear, to buy long-dated or irredeemable loans and convert them into short-dated loans when money conditions become cheap. It is not altogether impossible for individuals with limited means to repeat this process but this is how Investment Trust, Insurance companies, and Banks manipulate their invested funds. However, one will be unfortunate if he holds undated loans at high prices, and he may have to sacrifice a little capital even if he exercises the greatest caution to adjust himself to the foregoing planning.

This book is not, however, written for persons who have specialised knowledge on this subject, and as these are sensitive to coming events they can afford to keep funds in undated issues till the eleventh hour, always alert to switch on to safety investments on seeing disturbing factors loom on the horizon.

CHAPTER XI

The Yield

In the last chapter we have seen how the dated and undated loans are affected by various factors always basing our calculations on the yields. Well, what is yield? Yield is return. On investments it not only includes interest and dividends but the profit by capital appreciation or loss by depreciation in value also. It all depends upon what basis we adopt for our calculations.

In the case of the ordinary shares the yield is based on dividends alone, whereas the capital appreciation or depreciation forms a separate item. In the case of securities bearing fixed interest the yield is generally calculated on the ultimate anticipated returns including capital appreciation or depreciation, or on the market value. Again, it depends upon what value one wants to base one's calculations on, *i.e.*, whether on the price already paid or on the price at which the purchase is intended.

Thus, the 5 per cent. 1945-55 tax-free loan now standing at Rs.111⅛ gives the running yield as follows :—

$$\text{Rs. } 111\text{-}1/8 : 100 :: 5\% : x = \frac{100 \times 5}{111 \cdot 125} = 4 \cdot 5\%.$$

But this is not the correct yield ultimately obtained, for, the investor who invests in this loan now will lose on maturity Rs.11-2-0 for every Rs.111-2-0 invested, the loan being repayable at par. Therefore, in order to have cumulative net yield, we must deduct the loss on redemption from the above yield. The easiest way to do it is thus :—

		Rs.	a.
The cost of Rs. 100 tax free loan is		111	2
Taking redemption date as 1945, *i.e.*, 4 years to run, the total yield is : 5% × 4 years	=	20	0
Deduct capital loss on redemption		11	2
The total yield on Rs. 111-2-0 for 4 years	=	8	14

The yield per annum is therefore :

$$\frac{\text{Rs. } 8\text{-}14\text{-}0}{4 \text{ years}} = \frac{8 \cdot 875}{4} = 2 \cdot 22$$

But Rs. 2·22 is the yield on Rs. 111-2-0. Therefore, the yield on every Rs. 100 invested is :

$$\frac{\text{Rs. } 100 \times 2 \cdot 22}{111 \cdot 125} = 2\%.$$

This 2 per cent. will be the yield to the investors who buy now but not to those that already bought at a different rate, and if this security was bought long ago, say at par, then it will still continue to yield 5 per cent. and not 2 per cent. as is sometimes assumed because the

investor will get his capital back intact on maturity after receiving 5 per cent. per annum. No doubt, between now and the date of maturity Rs. 11-2-0 will be lost on every Rs. 100 worth of the loan, but lost from where? Not from the investor's pocket anyway. This is a paper loss only. The position will be slightly different if the person who had bought at par sells now, in which case he will get an appreciation of Rs.11-2-0 per every Rs.100 invested, but will lose the opportunity of getting the 5 per cent. yield he would get if he were to retain this portion of his investment until maturity. This capital appreciation of Rs.11-2-0, it must be remembered, will again earn interest if the total capital realized is reinvested elsewhere.

Some again get confused when thinking about conversion and with their own imaginings and unnecessary calculations get tangled and finally give up the idea of conversion that may have been recommended to them.

Conversion, in plain words is (1) the advantage taken by the holders of matured loans when Government offers to the public a new loan and accepts subscriptions in matured loans also, instead of cash; (2) the opportunity taken by the investor when there is difference in price

between two securities by selling his holding in one loan and reinvesting the sale proceeds in another offering better yield. It is this latter procedure that we are concerned with most, and it is scientifically followed by skilled and prudent investors for the purpose we discussed in the previous chapter. We will see later on how this is done.

The Government of India and other loans now existing carry varying rates of interest from 2¾ per cent. to 6½ per cent. Between 1921 and 1925 when money was dear many 6½ per cent. loans were issued, some of them Income-tax free. Even 7 per cent. was offered by Calcutta Port Trust to attract sterling loan in the London money market and Mysore Government made history by issuing a loan at 7 per cent. interest, free of Income-tax. Fortunately, most of these loans have since been repaid but there are still many that bear as high a rate of interest as 6½ per cent. Outstanding amongst them is one Mysore Government loan bearing 6½ per cent. Income-tax free interest.

All these loans are quoted at a very high premium, in one case, of Rs.43. Nevertheless, the yields, as compared with other loans of the same category are mostly very close and investors should be cautious while buying such loans.

Generally speaking, it is immaterial for a small investor who is not liable to Income-tax, whether he buys a loan that stands below par or one at a premium, provided the gross yields are the same. But those who are liable to Income-tax and Super-tax should give preference to loans that are quoted below par; the reason being that the taxes are assessed on the interest alone and not on capital appreciation, but regardless of capital depreciation, and since the securities below par give capital appreciation on maturity, they raise the ultimate yield. But if high interest rate security is selected for investment then the taxation problem will make all the difference although the gross yields may be the same. To understand this point thoroughly it will be best to take an example.

At the time of writing, 6½ per cent. 1951 Calcutta Municipality loan is quoted around Rs.124 and 2¾ per cent. 1948-52 Government of India loan around Rs.98. Both are repayable at par. It is reasonably certain that the latter loan will be repaid at the latest redemption date because it is the cheapest rupee loan ever raised, within our memory, by the Government of India. So these are two loans having a wide difference between the interest rates but having nearly the same currency, *viz.*, 6½ per cent., 10 years and 2¾ per cent., 11 years. To compare the ultimate

results yielded we will take them side by side as follows :—

	6½%@ Rs. 124 10 years.	2¾%@ Rs. 98 11 years.
Total yield is ..	6½ × 10 = 65 0 0	2¾ × 11 = 30 4 0
Capital loss or gain	—24 0 0	+ 2 0 0
Total gross income ..	41 0 0	32 4 0
Deduct 30 + 10 pies tax on total yield	13 9 0	6 5 0
Total net income	27 7 0	25 15 0
∴ Gross income per unit per annum is	4·10	2·93
Gross income per cent. per annum is	3·31	2·99
Net income per unit per annum is	2·74	2·36
Net income per cent. per annum is	2·21	2·41

From the above it will be seen that when the gross yield of 6½ per cent. loan is 3.31 per cent. that of 2¾ per cent. is 2.99 per cent. only—a difference of .32 per cent. in favour of 6½ per cent. loan. But see how things change when the Income-tax comes into play. The net yield on 6½ per cent. loan is reduced to 2.21 per cent. and that on 2¾ per cent. to 2.41 per cent. but inversely affecting the 6½ per cent. loan by making a difference now of .2 per cent. against it. Therefore, to those to whom Income-tax is not applicable, the high-interest loan will be better, for,

it yields .32 per cent. more than the low-interest loan but to those whose income is subject to tax, the low-interest loan is evidently paying.

We can also see from this that the 6½ per cent. Calcutta Municipal loan which is inferior to the Government of India 2¾ per cent. loan is unjustifiably high, yielding 2.21 per cent. net as against 2.41 per cent. net obtained at present on a superior security having almost the same redemption term. This difference will not appeal to small holders but the example is given here with the hope that investors will be able to take advantage of wide and disproportionate fluctuations often occurring when the markets are swayed by well-founded or ill-founded rumours.

In our calculations we have taken into consideration the maximum Income-tax of 30 pies in the rupee plus 10 pies Surcharge and those investors who are liable to this tax should give more attention to the foregoing method of arriving at the true yield.

Those, on the other hand, who are not liable for the full tax will, in accordance with their income, be easily in a position to find out for themselves in the manner suggested above what security will suit them best. Those whose total world income is below Rs.2,000 per annum are not liable to tax and, therefore, they should look

for the gross maximum yield after deducting, of course, capital loss on redemption. The tax in such cases when deducted at source is liable to be refunded and, it should be claimed from the Income-tax Authorities.

We have not taken into account the effects of Super-tax, and where this is applicable the holders of high-interest rate securities will be still more vulnerable.

It is confusing to some when loans bear two redemption dates. They have a great significance. It means that a particular loan will be repaid any time between the two periods quoted. Thus, the Government of India 2¾ per cent. 1948-52 loan is repayable not earlier than 1948 and not later than 1952, and in some cases we can judge fairly well beforehand, in what year a certain loan will be repaid. Under present monetary conditions we cannot expect the 2¾ per cent. 1948-52 loan to be repaid in 1948 because it is the cheapest, and therefore, it is almost certain that it will be repaid in the year 1952, unless monetary conditions take an unexpected turn. Similarly, the 5 per cent. 1945-55 tax-free loan can be assumed to be repaid in 1945 and those who plan on the later date will see their plans upset when it is repaid 10 years earlier.

While the yield on preference shares and debentures can be calculated on the foregoing

basis, that on ordinary shares is not calculated in the same way. In the case of ordinary shares we can know only the running but not the ultimate yield, for, we cannot know at what price we shall have to sell the shares, unless we take separately, as is usually done, appreciation as gain and depreciation as loss.

But, properly speaking, while taking stock of ordinary shares the yield should be calculated on the market rate, because it will show how the purchased share compares with the shares of the same class, and not on the price paid. While considering the sale or purchase, the investor should consider whether the yield on the market price is higher or lower. If lower, and if the same type of share is available at a better price, then he should sell his present holding and invest in the other share that yields more. We will illustrate this by an example.

[For the purpose of clarification we shall call the share that we already possess, "B." We will assume that the face value of it is Rs.100, that it was bought at Rs.100 and that its present price is Rs.133. The dividend paid on it is Rs.6 per year, yielding 4½ per cent. (on the market price.) Another share—let us call it "A"—the face value of which is Rs.100 and which also pays Rs.6 per annum is available at Rs.120, yielding 5 per cent.] That is, if "A"—an

equally good share,—is available to yield 5 per cent. due to its drop on account of unfounded rumours or, say, on account of the influence of bears, as against 4½ per cent. given by " B," the " B " should still be disposed of and the sale proceeds reinvested in " A."

This recommendation, it is certain, will not be acceptable to the investor of ordinary intelligence, for, he will ask " Why should I sell my share that yields 6 per cent. (on the cost price) and invest in the other that yields only 5 per cent. ? " The price paid has nothing to do with an ordinary share. The value of it is the price ruling to-day. To-morrow, it may be different. Though the cost price of " B " was Rs.100, it is quoted to-day around Rs.133 to yield 4½ per cent. But the other share of the same class which is also paying Rs.6 per share is quoted at Rs.120 and yields 5 per cent. Therefore, the argument in favour of conversion of " B " into " A " at Rs.120 is reduced to this :

	Face Value.	Cost.	Dividend.	Market Value.	Yield.
	Rs.	Rs.	Rs.	Rs.	%
" B "	100	100	6-0-0	133	4½
" A "	100	120	6-0-0	120	5

$$\therefore \text{Rs. } 120 : \text{Rs. } 133 :: \text{Yield Rs. } 6 : x = \frac{133 \times 6}{120} = \underline{\text{Rs. } 6{\cdot}65}$$

This means Rs. 6·65 per the converted value of " B."

That is, the total income we get on " B " is Rs.6 per annum and a capital appreciation of

Rs.33 if we sell to-day. But if you sell "B" and invest in "A," you pay Rs.120 per share in the first instance in order to get Rs.6 per annum. Now the total sale proceeds of "B" are Rs. 133 out of which you invest only Rs.120 leaving the balance of Rs.13. This balance when reinvested in the same share yields additional Rs.0.65 making the total yield of Rs.6.65 per the converted value of "B," *i.e.*, Rs.133, as against Rs.6 given by the original investment. This is not all. You sell a share that is now at Rs. 133 and invest in the same type of share at Rs.120 making it possible for your capital to appreciate by about Rs.13 (per every Rs.120 invested) in a short time.

The yield on the ordinary shares of a company, profits of which are on the decline, should not, properly speaking, be based on the last dividend paid as we cannot know what the next dividend will be. In all probability, it will be less than the previous one. It is equally difficult to guess what the next dividend is going to be of good companies other than Banks, Insurance and Electricity, but then we can confidently look forward to its maintenance if the trade conditions are normal, and even if there is a decline in the dividend, the ordinary shares will not be affected to the same extent as those of the other company the profits of which are destined to suffer.

CHAPTER XII

Types of Investors

Hitherto, we have attempted to describe the various outlets for capital which fall within the scope of investments and which, if pursued scientifically, can with reasonable certainty bring regular income throughout the investment period and give capital appreciation.

The first and most important thing for an investor to do before embarking upon investment is to define clearly his object in view; that is to say, with the money in hand he must plan for years ahead strictly in accordance with his own requirements and circumstances, taking into account the investments that he might already be having, and giving due consideration to all the possibilities arising in our normal life. Insufficient attention to this matter or ignorance, invariably results in neglect of basic principles underlying true or scientific investment. Unmethodical investors may, and do often find their investments come out successful in course of time, sometimes beyond their expectations. This is all due to chance. But they are also often disappointed and severely too, when their investments make a poor show due to their carelessly

investing their funds on the mere advice of their friends. But a methodical investor with a definite policy can almost always successfully invest his funds with the remotest possible risk of capital depreciation, which, at any rate, all investors should avoid. A systematic way will not make him rich overnight but will compensate him within good limits.

Before pressing this point further it is necessary first to define the various types of investors by taking them group by group, as the investment requirements of one differ considerably from those of another. A widow, for example, who is naturally expected to have no source of income from earnings cannot be in the same position financially and economically as a business-man, a professional, a young bachelor with great future possibilities or a high salaried executive, and therefore, for the purpose of facilitating our argument we will divide the investors into six broad groups, *viz.*, (1) bachelor, (2) newly married couple, (3) family man, (4) pensioner, (5) widow, (6) business-man.

A bachelor who, perhaps, holds a fairly promising position in an office, or a skilled or an unskilled labourer whatever the nature of his work may be, can, if his earnings exceed expenditure, take risks in the speculative ordinary shares with the hope that he may one day be

handsomely rewarded. He can also afford to go without adequate investment returns for some years and if investment is made in new companies or in old ones but in a depressed state—whose fate is not doomed—with the intention of as large a capital appreciation as possible, he can well afford to wait indefinitely without any dividends.

The change comes when he is married. He might have acquired a large dowry or may not have acquired any at all; or for all that, he may have connected himself with the poverty of his wife's people whom he will not like to ignore. Here he cannot do anything but go cautiously and change from haphazard ways if he has any and think twice before investment, particularly of the dowry. The best investment that might be recommended to him is Government or other allied loans including dated debentures, in which it would be advisable to place most of the dowry if it is received in cash, spreading the rest together with his other savings over good class preference and ordinary shares which will give a regular income and, as a matter of fact, increase the aggregate percentage yield.

A family man on the other hand who is assumed to be in service, and who must have had, by now, some experience of investments, is expected to keep his savings in such a liquid form

—not necessarily in Savings Bank—as to be able to draw upon them occasionally without any loss of capital. This money he may require for the purposes of higher education of his children, or of setting them up in business, or of dowry, if he has marriageable daughters. It would be advisable under these circumstances for savings to be placed in dated loans or debentures falling due at regular intervals. Some of them he will be best advised to keep in ordinary shares having future prospects of capital appreciation so that this may tend to offset his disbursements to a certain extent. This, of course, depends upon the financial position of the person and if his salary has to be supplemented by income from investments in order to meet his normal expenditure, then it would be advisable for a portion of his capital to be spread over a few well chosen good class ordinary shares of companies that have done well in the past, continue doing so, and have future prospects.

A pensioner, if his pension is sufficient to maintain his family, may be excused for having his savings in any ordinary and preference shares but if his pension is to be supplemented by the income from investments then he would be well advised to have a major portion of all the available funds in high-grade ordinary shares giving a reasonably satisfactory yield so that the average returns may be raised to the highest possible

degree compatible with safety of capital. This again depends upon the economic circumstances of his house, family and his age.

In the event of a person obtaining a gratuity or provident fund, it would be advisable to have a major portion of such money in dated loans or debentures with the rest evenly distributed amongst good ordinary and preference shares. The proceeds of a matured insurance policy may also be treated likewise.

We know of many cases where widows have been victims either owing to the ignorance of their so called friends and financial advisers or to being duped by "professionals." A widow, if she has no guidance of an experienced person on this subject, should stick to fixed dated Government and Provincial loans only, having varying dates of maturity, regardless of her circumstances, unless she has a sound knowledge of this subject. But if the income produced by such an investment fails to provide her with a comfortable living then she should consult an expert in this matter who can be expected to arrange her investments or funds in such a way as will give her maximum yield possible compatible with safety of capital. And if this is still insufficient, then the last recourse would be the realization of a fraction of the capital at regular intervals in accordance with the circumstances

of the case, this being arranged in such a way as to dissipate the capital systematically as she approaches her last days.

The position of a business-man is quite different. He may require his surplus capital always in a liquid form to meet his business demands; he is, if not, usually in a position to play with funds in the manner he desires, either by speculation, investment or in any other form that may be pleasing to him, with the hope of greater reward. Such persons rarely require guidance from investment advisers, but should they need any, then it would all depend upon the funds they have available and other circumstances surrounding them.

These are only broad divisions of persons that we come across in normal life but every person in each group cannot be and never is on the same footing. One bachelor might have, for instance, inherited a large fortune through a legacy, enabling him to live very comfortably on its income alone, but another bachelor, on the other hand, may have small savings out of his own efforts which he wishes to multiply.

This dissimilarity of investors defies accurate grouping into convenient divisions and for the purpose of avoiding confusion, we will place them in three broad divisions according to their economic and financial circumstances.

1. Persons whose salary or professional or business income is sufficient for a comfortable living and who, therefore, at the present moment do not need the investment income.
2. Persons who partly depend upon the earnings and partly upon the investment income.
3. Persons who have no earned income but who depend entirely upon the income produced by their investments.

But this again does not solve our problem nor can it be solved within the scope of this book, unless an attempt is made to analyse investors with more precision involving so many complications that they will only make our point unintelligible instead of clarifying it.

It will not be difficult, however, for the investor who knows his circumstances well to draw an investment plan for himself in accordance with his own requirements and on the lines that will be discussed in the next chapter.

CHAPTER XIII

Investment Portfolio

Having described the types of investors in the last chapter we will here attempt to see how funds may be scientifically invested to meet the requirements of individual investors who differ considerably from one another in financial circumstances and resources.

In countries like Britain and America, investors are usually in a position to spread their funds over a wide range of investments, because their earnings and savings are, owing to economic causes, far more than those of Indian investors ; and it may be safely assumed that their average investments are ten times as much as those of the unfortunate Indian investor. Since the small funds of the Indian investor can be spread over a small and limited range only, the investment procedure differs scientifically and psychologically from that in the case of big capitalists. This, it will be deduced, makes the problem of investment difficult for the Indian investor, and the more so because he already suffers from want of adequate knowledge on this subject.

Nevertheless, useful lessons can be learnt from the investors of the above two countries,

particularly from the Investment Trust companies which specialise in the business of investments alone, in order to cultivate basic principles and lay on them a foundation for a sound policy designed to meet individual requirements. Of course, with a very small amount in hand we cannot try to imitate the investment policies of Investment Trust companies but we can certainly profit by the prudence with which they distribute their huge funds. Another lesson which we can learn from the fact that, in spite of all their prudence, foresight and experience, they have not been able to maintain dividends during the periods of depression, is that the demon of depression affects everything, whether good or bad with the only exception of very short dated fixed-income securities. It must be remembered, therefore, that if the earnings of such companies with skilled persons in the background are liable to set-backs, we, with limited means, should be still more so. One point, however, must be stressed here. The Investment Trusts that had paid less attention to the cyclic and monetary conditions were hit harder. If we avoid this mistake by paying more attention to these factors which we are emphasizing everywhere in this book, then we can well endure the pangs of depression or the effects of changing monetary conditions, if not actually turn them to our advantage.

To refute this argument some critics might point to the investment policy of the Indian Insurance companies, most of the funds of which are now invested in long dated securities. Now, there are two reasons why this is so. The first one is that that is the only safe place where they can incubate their funds so that, being always sensitive to adverse factors affecting investments, they may manage to avoid consequences for which unskilled investors have to pay dearly. The second and the more important one is that, on account of the compulsion of the Insurance Act to invest at least 55 per cent. of their funds in Government or other similar securities and of the very unsatisfactory yield of about 2 per cent. available at the present moment on such investments, they are reluctantly forced to invest where their funds will seek higher yield. The only place, therefore, where they can invest is in long dated or perpetual securities. The writer will perhaps be excused if he goes out of the way to remark that, if the relevant section of the Insurance Act is not amended or relaxed, a financial chaos as money tends to become dear, will be inevitable. And we shall not have to wait very long to see it.

It may be immediately answered here to those investors who had made a lot of money over their holdings purchased about 10 to 15 years ago without any sort of planning and who

may like to ask why, under the circumstances, they should now follow any policy at all. Such persons are few. Any person who invested 15 years ago, *i.e.*, before the great depression of 1931-32, when prices on the whole were high, must have suffered severe shocks during the depression and also after it owing to unfavourable trade conditions, and even if through nervousness he did not unload during those periods, still he could not have been very well rewarded on the whole.

Until a few months ago, despite the war demand placed on almost all the Indian industries, prices on the whole were lower than those ruling about 15 years ago. Jute shares, for example, which were then quoted at a higher level than they are now, ruined many an unmethodical investor. So also the shares of other companies such as Tea, Rubber and Textiles. If some investors who had their funds in Bank, Insurance and Electricity companies were fortunate, many, within the author's experience, who had an inclination to certain speculative shares and who had disproportionate investments, have suffered tremendously.

Coming back to Investment Trust companies, we must first mention that although their first consideration is capital safety, their aim naturally is to obtain a higher income on their

investments than that required to meet dividend and interest obligations. Here investors differ slightly. The first consideration of those that have to supplement their earnings by income from investments is to get as much yield as possible and yet to look to the safety of their capital. But this is not strictly so with all investors. As we have seen in the previous chapter, there are some persons who only partly depend upon their investment income and some do not depend on it at all, the first consideration of the latter type being as much capital apprecia-tion as possible.

From the published tables of some of the Investment Trust companies showing the classi-fication of their investments, it is found that, on an average, they place their funds approxi-mately as follows :—

Government loans and debentures ..	25%
Preference shares	25%
Ordinary and deferred shares ..	50%
	100%

There are some companies, of course, whose distribution varies. To take extremes, some increase their risk by investing about 75 per cent. of their funds in ordinary shares and some take a very small risk, say, by placing as little as 20 per cent. only in ordinary shares. It all depends, however, upon the policy which they wish to

pursue and which they change as and when circumstances demand.

If these experienced investors think it advisable to have 50 per cent. of their capital in fixed-interest securities and 50 per cent. in ordinary and deferred shares, we can do nothing better than follow their principle for our average requirements.

Prior to drawing up a scheme for investment several things are to be considered and a few hints may be given in that connection.

It is generally thought that spreading over investments in as wide a range as possible is always an advantage, but experience teaches us that this is a fallacy. This policy is harmless only if pursued by specialists who may have a special motive in doing so. But to the uninitiated or to those having a limited knowledge of this subject and of the trade conditions as a whole, it is a disadvantage, for it calls for much more care and attention than such investors can give, and ultimately the whole scheme ends in confusion, resulting not infrequently in capital loss. The best mode for an individual investor is, therefore, to make a selection of only a few companies whose business activities and financial position are not difficult to discern.

In accordance with one's requirements, investment may necessitate the selection of

shares that will give a stable and regular income. While fixed-income shares and securities will meet the demands of such an investor, he should not lose sight of the possibility of these holdings landing him in difficulty in times of dear money or depression if they were bought while money was cheap, without due regard to the redemption dates. This applies particularly to those who may have occasion to realize a portion of their capital at any time, and although selection of fixed-interest shares and securities will give them the pre-determined yield even during an acute slump or during a period when money is dear, it will not enable them to withdraw capital during such periods without the loss of capital unless some portion of the capital required to meet the anticipated demand is placed in short dated securities.

It is found from experience that it is necessary to create a sort of a reserve fund to minimize the risk of capital depreciation. This fund may best be in the shape of short dated loans or debentures. Its function is to lend support to depreciated investments by means of liquidating short dated securities without loss of capital and re-investing the sale proceeds in depreciated shares. This will tend to average prices.

Time also plays an important part. What is suitable to a man of 40 will evidently not be

suitable to a man of 50 even if the circumstances of both are alike. The man of 40 may like to take a certain amount of risk in some speculative ordinary shares which, if they let him down, will not trouble him as much as they will a person of 50 who will hardly have sufficient time and energy to make good his loss. Similarly, investment planning to-day may have to differ very much from that we may have occasion to do a few years hence. Now, money is very cheap, necessitating a tendency to increase holdings in short-dated securities; whereas this point can almost be neglected if we have to compile our investment portfolio during a slump or during a period of dear money, because, as we discussed before, we shall be able to make our purchases at a low price, which will eventually appreciate or at least remain around the purchase price enabling the holder to realize capital, whenever wanted, without loss. This, however, will not be the case if we enter markets while money is cheap and prices high, for, if purchases are made at this period of long dated or non-terminable loans we shall have to hold them at a high price when money conditions change. Such holdings amount to, as an American puts it, a sort of " fly-papers on which we get permanently stuck."

There is also an impression that rich men do not necessarily need investment planning in view of their huge resources. It may be so;

but no one will deny the fact that a good and systematic planning will keep him free from anxiety with as much possibility of fulfilling his object as otherwise. In the case of haphazard ways this benefit will be sadly lacking and he will even have many a sleepless night, particularly when his favourite scrips let him down. Generally such persons take interest in some industries and invest a major portion of their funds there to make fortunes with the boom but never to crash with the slump.

This recalls to mind a list of holdings that was submitted for the writer's criticism. It was in 1938. An investor had holdings of roughly Rs.2½ lakhs, three-quarters of which were in jute shares, evidently because he was a Calcutta man with more inclination towards jute industry. Investment was made in the year 1926-27 when jute shares had touched almost peak prices. From what little information is available, it would appear that this person, induced by the prosperity of the jute industry, decided to increase his jute holdings disproportionately, which landed him in trouble. We can well imagine the feelings of this investor when we know that at the time the list was submitted for criticism his jute holdings, on an average, had depreciated by over 50 per cent.

To come to our subject, the question may be asked, " how to start with our investment

business?" The counter question is, "from where?" It may be that an investor already has some holdings and it is first necessary to take stock of these. If he has more capital in ordinary shares, then it obviously should be seen whether it is in sound shares. If not, liquidate the bad investment and reinvest the sale proceeds with the available fresh capital. If on the other hand all the ordinary shares held are good then the investment of the fresh capital should take into consideration this fact and avoid increasing ordinary holdings if the scheme necessitates such an action. Similarly, holdings other than those of ordinary shares may be taken stock of and treated accordingly.

Before drawing up an investment scheme it would be advisable first to consider thoroughly economic and financial circumstances. Insurance which almost all investors should have, is good, primarily because it is a forced saving. Without insurance we do not know what we might have done particularly those who are in a position to put by a small surplus of their earned income. It is very likely that we might have squandered it each month on attempts, however honest, to multiply it through many types of promising evils that surround us. Insurance is, therefore, a blessing to those who just start in life and it would be advisable for such persons to take the shortest possible endowment policies,

which, on maturity could be profitably employed by being invested with a view to multiplying savings or to increasing income. This might have particular reference to a bachelor who has no one to support, or having some one, still is in a position to save. The circumstances of a married man differ. So also of a middle aged man and of others that we have discussed in the last chapter. For a man with a family the only insurance advisable is the whole life policy with limited premiums (either with or without profits). To him such an insurance will give some liberty to employ his savings in an investment with some hope of future capital appreciation and diminish his fear for risk of depreciation if the circumstances went against him.

CHAPTER XIV

Investment Portfolio—(*contd.*)

It is proposed in this chapter to draw a few schemes only for the purpose of guiding investors of various types described in an earlier chapter. They are by no means suitable for all investors but are intended to assist all at the time investment is considered. To start with, we will assume investors possessing investments and cash to the tune of Rs. 10,000 and over.

Before proceeding, a point which we have previously discussed must be repeated here. We have already discussed at length the influences exerted by changing monetary conditions on fixed-interest shares and securities, which summed up, simply means this: When money is dear fixed-interest shares and securities are cheap and when money is cheap they are dear. While compiling our investment portfolio, therefore, it is of paramount importance first to concern ourselves with the trend of the existing monetary conditions and of the trade, and do the planning accordingly. Similarly, the possibility of market booms and slumps which recur every few years, but not with the same severity, must be taken into consideration. In boom periods every share, whether good or bad, and in sympathy, every security, appreciates far above its intrinsic value—save very short dated fixed-interest securities which are controlled by redemption dates.

Conversely, they depreciate considerably during a slump. In the circumstances, it is necessary for us to divide the requirements of the individual investor into two distinct schemes, one incorporating recommendations when money is cheap or the market is experiencing a boom and the other when money is dear or there is a slump.

We will represent the scheme suitable during the periods of cheap money or boom by "(*a*)" and that suitable during the periods of dear money or slump by "(*b*)".

SCHEME I. We will first consider the case of an investor who, with his total monthly income other than that produced by the investments he may already be having, can live with reasonable comfort. This investor wishes to accumulate as much capital as possible to provide for his old age. He can take a small risk with the hope of a better reward. At the same time he expects that at some future dates he will require some capital for educational and other purposes. For a person under such circumstances, the following would be advisable :—

In Period (a) :

Ordinary shares	Electricity	15%	
	Insurance	15%	
	Banks	15%	
	Miscellaneous ..	10%	55%
Short and medium dated securities and debentures ..			45%
			100%

It will be observed that 55 per cent. of the capital has been recommended for investment in ordinary shares, 45 per cent. of which has been allocated to high class Electricity, Insurance and Bank shares. The yield on these shares under such conditions will be small but our object is capital appreciation which is bound to be fulfilled sooner or later. This ratio in any other type of ordinary shares such as Industrials would not be advisable as they have a tendency to depreciate heavily in times of depression. Not so the recommended class of shares and even if depression had to come five years after investment was made, the holder would not be losing any portion of his original capital, for, during the period of these five years his capital would have appreciated to a reasonable extent, which increase alone he might lose. The 10 per cent. may be placed in good ordinary shares of miscellaneous companies that have done well in the past, that continue doing so and that have future potentialities.

Nearly half the capital has been allocated to short and medium dated securities and debentures. Out of this about three-quarters may be given to short dated and the other quarter to medium dated securities. The reason for this is obvious. Since money is cheap or the prices high, the 45 per cent. of the capital has been kept liquid so that in the event of the shares in general

depreciating or of the investor coming across a good opportunity, he can easily convert undepreciated holdings into depreciated shares which might not have been possible had be kept this portion of funds in long dated securities. This will also enable the investor to realize capital whenever wanted without loss.

In Period (b):

Ordinary shares	Bank	10%	
	Engineering	10%	
	Tea and Rubber	10%	
	Industrials	20%	
	Miscellaneous	15%	65%
Preference shares			10%
Long dated and irredeemable securities			25%
			100%

Note the fundamental change here. Although percentage in ordinary shares is increased only by 10, the whole technical aspect of the ordinary holdings is changed. Electricity and Insurance shares have been purposely omitted. Bank shares generally depreciate more than the other two classes of shares and, therefore, they have been given preference for investment during a slump. But this is not essential as selection of any of the three classes will not give wide variation in results. Engineering, Tea, Rubber and Industrial shares have been added because they are highly fluctuating and, therefore, at this period they will have been quoted around the lowest figure, Industrials

may represent Jute, Sugar, Cotton, Coal shares, etc., Steels having been accounted for under Engineering. Market leaders do not necessarily give best results at this juncture and the shares of the companies whose financial position is sound will give as good a result, if not better than market leaders. There are hundreds of Miscellaneous shares but it will not be difficult to make a selection of good shares.

Only a small percentage of preference shares has been included in this list to add strength. This will give a good yield and ultimately appreciate capital, but to a limited extent.

From 45 per cent., the short and medium dated loans have been reduced to 25 per cent. but in long dated and irredeemable issues. This percentage is retained in order to strengthen the general position of the investment portfolio. These holdings, at the same time, will appreciate in course of time apart from giving a high yield.

One point to which attention must be called here is this. We have assumed that this investor will be wanting some capital at a future date and in accordance with the system we have been advocating, no provision is made for withdrawal of capital at an unexpected time. The reason is simple. During a slump, when everything is affected with the exception of short dated securities, it is reasonably certain that selection

will have been made at low, if not the lowest prices. Therefore, the holdings will have to move on one side only, that is, upwards, enabling the investor to realize a portion of his capital whenever wanted without any loss.

SCHEME II. We will here consider the case of an investor who partly depends upon earnings and partly upon his investment income, the total of which he wants to be well over his expenditure. He also wishes to be able to withdraw a portion of his capital after a short while. One of the considerations with this investor is capital appreciation compatible with safety. But since he also requires income from investment to supplement his earnings we have to arrange his investments in a different way. For a person like this the following is recommended :—

In Period (a) :

Ordinary shares	Electricity	10%	
	Banks	10%	
	Insurance	10%	30%
Preference shares			25%
Short and medium dated securities			25%
Short and medium dated debentures			20%
			100%

This scheme is drawn on the basis that no appreciable risk of capital is involved. Only

30 per cent. is placed in ordinary shares but of a high class which although do not give a high yield, hold possibilities of capital appreciation in course of time.

The preference shares to which 25 per cent. of the capital has been allocated should be placed in companies whose profits give a good cover to the dividend requirements of their preference shareholders. Preferably, they should not be low yielding. Selection of shares that have participating rights would be an advantage even if a comparatively high price is paid.

Again 25 per cent. has been allocated to Government and other allied loans. This, it will be noted, is in short and medium dated securities for the investor to be able to withdraw a portion of his capital without loss and for other reasons already given under Scheme I. Most of this portion of capital may be placed in Provincial and Local Bodies loans as they are higher yielding.

The balance 20 per cent. has been allocated to debentures which should be well covered and preferably be short or medium dated. The idea underlying the recommendation of debentures is to increase the average yield because they are higher yielding than Government and other allied loans.

In Period (b):

Ordinary shares ..	Bank or Electricity.	10%	
	Industrials	20%	
	Miscellaneous ..	15%	
			45%
Preference shares			30%
Long dated and irredeemable securities			25%
			100%

The basis of investment in ordinary shares has been increased from 30 per cent. to 45 per cent., drastically reconstructing the technical position, in that only 10 per cent. has been retained in Bank or Electricity shares, investing the balance 35 per cent. in speculative shares. This is permissible because monetary conditions are different and the prices of shares and securities will tend to harden as normal conditions return.

The holding of preference shares has been increased from 25 per cent. to 30 per cent. This will give a high yield and capital appreciation.

Leaving the same percentage, the short and medium dated securities have been replaced by long dated and irredeemable securities for reasons given under Scheme I.

Debentures have been omitted altogether because there is not much risk of capital involved under such circumstances.

SCHEME III. Here we will consider the case of an investor who entirely depends upon the income produced by his investments, there being no other income whatsoever. His natural anxiety is for the safety of capital, and his desire is for as much yield as possible with stability of the same.

Obviously, the smaller the capital is, the more difficult it is to arrange planning so as to meet the investor's requirements under such circumstances, but the following recommendation will be helpful.

In Period (a):

Ordinary shares	Electricity	10%	
	Insurance	10%	
			20%
Preference shares			30%
Short and medium dated securities			30%
Short and medium dated debentures			20%
			100%

Despite the fact that safety of capital is of primary importance to this holder, 20 per cent. of the entire capital has been exposed to risk to which ordinary shares are liable, but this risk can definitely be reduced to insignificance if over 10 per cent. is invested in good Electricity concerns and the balance in prospective Insurance companies that have merited the attention of the investing public. These two classes of ordinary shares have been recommended for the purpose of increasing income and capital. They have

been selected because their earnings are not generally liable to setbacks on account of bad trade, particularly those of Electricity Supply companies. As a matter of fact, their earnings always tend to rise.

Preference shares have been allotted 30 per cent. of the capital which, to a critical eye, may look too much in times of boom; but it was necessary to take a slight risk with the object of obtaining higher income. Here again it would be advantageous and preferable to include shares that hold participating rights.

Short and medium dated securities and debentures have been allowed 50 per cent. of the capital for reasons which will be found in Scheme I (*a*). Provincial loans and those of other Public Bodies will give a shade better yield than the Government of India loans, and therefore, the former may be given preference, if maximum income is to be extracted out of the capital.

To some, the income produced by this scheme may be sufficient, and to some not. In this latter case the holdings of debentures and securities may be slightly reduced and ordinary holdings, particularly of Electricity shares, correspondingly increased, involving, as it will, extra risk of capital. Bank shares may also be added. Without doing this, we can see no other way to increase income to the required extent.

In Period (b) :

Ordinary shares	Electricity	10%	
	Insurance	10%	
	Bank	10%	
			30%
Preference shares			30%
Long dated and irredeemable securities			30%
Long dated and irredeemable debentures			10%
			100%

The change here, despite the fact that even during this period the income produced under Period (*a*) would be stable, is noteworthy. When we can get shares and securities at a low price, it would be folly to invest in the manner suggested under Scheme III (*a*) above, particularly in short and medium dated loans which will demand a high price. Besides, the ordinary shares, which will be available at depreciated prices, will reduce the capital risk to almost nil. We have, therefore, allowed 30 per cent. of the capital for ordinary shares of Electricity, Bank and Insurance companies.

The percentage of preference shares, which under these circumstances will appreciate, remains constant.

Long dated and irredeemable securities and debentures take the place of short and medium dated loans with 10 per cent. decrease in debenture holdings. These will also appreciate in addition to giving a higher yield.

SCHEME IV. This is a case of a person who has regular income from earnings which is sufficient for the maintenance of his family. Half the capital he has is required for the education of his children or for setting them up in business or profession. He does not require it now but from about 2 years hence and at determined times but before 12 years. He does not much care what the yield is but his primary consideration is safety of capital and appreciation in order to offset, as far as possible, the deficiencies made by regular disbursements. For a person under such circumstances the following is recommended :—

In Period (a) :

Short dated securities	.. ..		60%
Ordinary shares ..	Electricity	20%	
	Bank and/or Insurance	10%	
	Miscellaneous	10%	
			40%
			100%

Half the capital, in this case is required to be absolutely liquid so that requisite funds can be withdrawn at a moment's notice without the loss of capital, but 10 per cent. extra has been made liquid in order to meet any emergency and as a reserve against possible depreciation of ordinary shares in which event this 10 per cent. will serve for the purpose of averaging. This portion has been placed in short dated loans which

bear redemption dates recurring at regular intervals. It is hardly necessary to emphasize that investment in securities in a case like this should be made in such a way that the dates of maturity nearly coincide with the predetermined dates of liquidation. From the market quotation of the dated loans which always bear the redemption dates, it is very easy to select in accordance with one's requirements and if money is required at intervals of every 2½ years or so, scrips can be easily selected to meet such demands from the wide range of loans that are always available.

In Period (b) :

Short and medium dated loans			50%
Ordinary shares	Electricity	10%	
	Bank and Insurance.	10%	
	Engineering ..	10%	
	Industrials	10%	
	Miscellaneous ..	10%	
			50%
			100%

From 60 per cent., the percentage in loans has been reduced to the minimum of 50 per cent., replacing some portion which will be required at a later date by medium dated loans. The reason for doing this is that the medium dated loans will be available at slightly depreciated prices so that there will be hardly any risk of capital being depreciated. Besides, by the time we approach the assumed end of 12 years these will automatically become short dated,

appreciating capital regardless of monetary or trade conditions, if they were secured below par.

Long dated issues can be an advantage here only if we have reason to believe that money conditions will not go worse. That is, if we feel that we are at the extreme end of dear money conditions or a slump then only is it worth while taking a risk; otherwise, if after buying long dated issues the decline continues, this investor will be in a difficulty. However, 15 per cent. of the capital is the maximum that is permissible in long-dated issues, in such a situation.

The percentage of ordinary shares has been increased by 10 per cent. and spread over five classifications. This will tend to appreciate capital to a great extent should selection be made of sound companies of each group without paying too much attention to market leaders.

* * * * *

SCHEME V. Let us assume another case of a person who has got idle capital and whose earnings are sufficient to give him a decent living. He is a reckless person and, therefore, does not much care for yield or capital safety. These he is willing to subject to risk provided he is confident of an ultimate handsome reward in the way of capital appreciation. The following ought to be suitable for a person of this type.

In Period (a) :

Ordinary shares	Electricity	20%	
	Insurance or Bank ..	10%	
	Industrials	10%	
	Miscellaneous ..	20%	
	Engineering ..	10%	
			70%
Short dated loans and debentures			30%
			100%

Out of the 70 per cent. capital allocated to ordinary shares, 40 per cent. is in speculative shares, *viz.*, Industrials, Miscellaneous and Engineering, and the other 30 per cent. are kept in shares of Electricity, Bank and Insurance companies for the purpose of double function (1) as a hedge against depreciation (2) for capital appreciation. In a case like this, market leaders may be included if the investor is able to follow the markets and take advantage of the speculative rises and falls. Otherwise, he should ignore them altogether and invest in companies that are less known but sound and have shares of smaller denominations, because in the event of activity in a particular branch of industry, these shares come immediately into prominence and quote proportionately higher than the market leaders.

Thirty per cent. of the capital has been retained in short dated loans and debentures only for the purpose of functioning as a reserve fund. It is clear, therefore, that its purpose

is to avail itself of opportunities whenever occurring after investment is made.

In Period (b):

Ordinary shares	Bank ..	10%	
	Tea and Rubber	15%	
	Industrials ..	20%	
	Engineering	15%	
	Miscellaneous	20%	
			80%
Preference shares			

Only one-eighth of the entire 80 per cent. of the capital allocated to ordinary shares is in Bank shares, the other seven-eighths being exposed to risk, but this selection will give a good account of itself when recovery takes place. Here again, market leaders may be neglected. So also shares of bad companies. The medium type of shares will be better, for, they suffer much during depression and are also quick to recover.

Preference shares, to which only 20 per cent. has been allocated, will serve to appreciate capital as those shares and securities that are undated depreciate considerably during such periods.

Persons in any of the above five cases may have insurance policies which may fall due shortly after investments are made according to the recommended planning, and in such a

case it would be advisable to distribute proportionately the realization of the matured policies amongst his various holdings so that the technical position is not changed fundamentally. In the event of the investments behaving in an unsatisfactory way owing to some factors affecting a certain industry as a whole, then the insurance funds will serve the very good purpose of averaging.

The foregoing schemes, it will be noted, have been prepared bearing in mind that investors are capable of investing Rs. 10,000 and over. But what about those possessing below Rs. 10,000? It must be confessed that this question is somewhat problematic, not because it is difficult to make selections but because the available funds, being small, do not permit of a proper distribution of risk. However, as far as the funds will permit, it would be advisable to take figures of the above schemes as the basis and invest proportionately. Where the funds fall below Rs. 5,000, extreme caution is evidently essential and in order to manage funds in the best way possible, it may be desirable to drop one or two classes from those recommended. For example, under Scheme I (*a*), Insurance and miscellaneous shares, or even Bank and Insurance shares, may be dropped in order to make it possible for the investor to buy shares available in minimum lots, thereby avoiding payment of

higher prices while buying and lower prices while selling usually demanded for small odd lots, and at the same time keeping the aggregate percentage, *viz.*, 55 per cent. unaltered. These principles will, however, have to be relaxed in the case of a person who is well in a position to put by a substantial portion of his earnings regularly for the purpose of investment. In this case, the Rs. 5,000 or less may be invested in good class ordinary shares in accordance with the degree of safety he requires, and future available funds in securities and preference shares to complete a perfect investment portfolio.

All the schemes recommended above are useful to those investors who enter the market while it is at either of the extremes, leaving each investor to make adjustment under their guidance if he has occasion to invest when conditions are different.

The inference, however, from the foregoing planning is that we must invest in short-dated fixed-interest securites when money is cheap or when there is a boom, or both; and in long dated securities when money is dear or when there is a slump, or both, as the former will prevent depreciation and the latter will give appreciation. Similarly, it is advisable to give preference when investing during a boom to ordinary shares of companies whose earnings

are stable or on the up-grade, such as Electricity, Insurance and Banks, changing to Industrials and other speculative shares as the conditions become the reverse. It must be borne in mind that it is inadvisable to buy too many ordinary shares during a boom as the investor is likely to be caught at high prices.

It will be readily appreciated that it is not possible within the scope of such a book as this to discuss all aspects affecting investment lists and thus prompt the investor to turn them to his advantage. Even if this were possible, we should never know when anticipated opportunities would occur, particularly in our times, when often the unexpected happens. It is felt, however, that the investor will be guided, as far as possible, by the schemes given in making his own planning, taking into consideration the existing circumstances and giving due regard to the trend of money and trade.

CHAPTER XV

Reorganization of Investment Portfolio

Howsoever good a selection of shares and securities may be, it always requires constant supervision in the same way as the mill-hands require that of their Foreman, if the best results are to be obtained, and we have said in the last chapter that it is absolutely essential for those who have invested without any type of planning to set their investments in order before taking another step in this field.

In that chapter we have mainly dealt with the available funds of the investor without paying much attention to what he may have already been holding but all the while stressing the point that before making an investment he should take stock of his holdings if he possesses any, and include these in the investment scheme he has the occasion to draw after effecting reorganization.

The primary reason why reorganization of the investment portfolio is essential is obvious. When a portfolio is compiled during certain circumstances it must logically be reorganized when these circumstances change.

There must be many who have already invested all their available funds without any

sort of planning and after going through the last chapter they will naturally be anxious to know whether their capital has been invested in accordance with the principles we have been advocating. Whether it has been or not, it will be easy for them to find out. If not, they will have to start in a different way and it is hoped that this chapter will help them.

Another reason which makes reorganization of investments essential is to turn abnormal times to one's advantage. Whether investment is made in accordance with some sort of planning or not, selections are always made in the hope that they will fulfil the investor's common object, firstly, safety of capital and then appreciation or regular income as the case may be. But it so happens that even after investment is made on the lines recommended in the foregoing chapter, one or more of the shares in the portfolio rise or fall beyond expectation and so unbalance the scheme.

When this happens and when it is found that some of the holdings have been appreciated far above their intrinsic value through speculative support but without any fundamental cause, there is no reason why advantage should not be taken of such a rise. This will enable the investor to snatch the unexpected handsome profit his investments are giving him, and which does

not exist unless the holdings concerned are liquidated. The reason for the reluctance to sell at this opportune moment other than the trouble involved in sale and repurchase, may be that he is unable to find out equally good shares for reinvestment. If this problem confronts him and if really there are no equally good shares available in the market then there is still an alternative. It is to convert that portion of capital which has had an unhealthy rise into fixed interest shares or securities, or better still, to hold the sale proceeds in hand but only until such time as the markets settle and either the same shares or others, equally better, are available at lower prices.

In the same way bad holdings which have no immediate hope of recovery may be liquidated and the sale proceeds reinvested in the same type of shares. Obviously, there will be a greater reluctance to sell at this juncture at a considerable loss, but before his investments come to such a stage the reader who has read thus far will know how to minimize losses if not actually to avoid them. In case some of the holdings have depreciated considerably solely on account of speculative reasons, the "reserve fund" specifically created for this purpose will help the investor to take advantage of the situation.

Well then, how to start with the investment business if in addition to our having cash we have

investments also? This would be the simplest procedure. First take stock of your holdings and prepare a list thereof. Then draw a few columns and put in them the number of shares held, the original price paid per share, their present market value, the total value originally invested in each company, the total present value, last year's income per share, the total income from each company and lastly the yield per cent. on the market value. Then total the necessary columns. This will put the investor in a position to know exactly where he stands. It will show him how many of the holdings have fulfilled his expectations and to what extent. If they have not, then they will also show to what extent they have failed. The totals will show whether or not the capital is appreciated and from this, percentage of appreciation can easily be worked out. From the total income produced per annum it will also be possible to find out the yield per cent. per annum. And then the yields on the individual holdings will go a long way to say whether the shares are worth holding any longer or not.

Again, from this it will not be difficult to find out the percentage of capital placed in different types of shares and securities and thus see to what extent his capital is exposed to risk. This way he will be in a position to survey his investments as accurately as possible and effect

alterations, additions or amendments wherever necessary to suit his own specific requirements.

To take a practical example we will take the list of an investor who invested about Rs. 15,000 in the year 1938. He made investments not in accordance with a definite plan but in accordance with what was recommended to him by his friends. The following are his holdings, and we will see exactly where he stands to-day and make some suggestions for improvement if this is possible:—

Name of shares.	No. of shares.	Face value of shares.	Price paid per share.
		Rs.	Rs.
Anglo-India Jute Mills, Ord. ..	5	100	320
Do. ..	3	100	275
Budge Budge Jute Mills, Ord. ..	5	100	255
Andhra Valley Power, Ord. ..	1	1,000	1,675
Indian Iron & Steel, Ord. ..	25	10	60
Do. ..	25	10	35
Alcock, Ashdown & Co., Ord. ..	5	100	300
Equitable Coal, 6% Tax Free Cum. Preference	10	100	134
Burn & Co., 7% Tax Free Cum. Preference	10	100	145
Indian Copper Corporation, Ord.	300	2 *sh.*	3
Ahmedabad Advance, Ord. ..	5	100	300
Spence's Hotel, Ord.	200	2	5

Having got the list of the investor, we will proceed to scrutinize in the manner recommended above.

NAME.	Type.	No. of Shares.	PRICE. Original	PRICE. Present.	TOTAL. Original.	TOTAL. Present.	Last Year's Income. Per share.	Last Year's Income. Total.	Yield % on present price.
			Rs.	Rs.	Rs.	Rs.	Rs. a.	Rs. a.	
Anglo-India (Jute)	Ord.	5	320	350	1,600	1,750	22 8	112 8	6·4
Do.	,,	3	275	350	825	1,050	22 8	67 8	6·4
Budge Budge (Jute)	,,	5	255	395	1,275	1,975	27 8	137 8	7·0
Andhra V. Power	,,	1	1,675	1,755	1,675	1,755	[illegible] 0	75 0	4·3
Indian Iron	,,	25	60	32	1,500	800	2 4	56 4	7·0
Do.	,,	25	35	32	875	800	2 4	56 4	7·0
Alcock, Ashdown (Eng.)	,,	5	300	660	1,500	3,300	20 0	100 0	3·0
Equitable Coal	Pref	10	134	155	1,340	1,550	6 0	60 0	3·9
Burn & Co. (Eng.)	,,	10	145	174	1,450	1,740	7 0	70 0	4·0
Indian Copper	Ord.	300	3	2/2	900	638	9 8*	28 8	4·4
Ahmedabad Advance	,,	5	300	350	1,500	1,750	10 0	50 0	2·9
Spence's Hotel	,,	200	5	2	1,000	400	Nil		..
					15,440	17,508	..	813 8	4·65

* Approximate net income per 100 shares.

The original invested amount of Rs. 15,440 has appreciated to Rs. 17,508. This means 13 per cent. appreciation over a period of three years and on the aggregate annual income of Rs. 813-8-0, the yield works out to 4.65 per cent. per annum on the market value and 5.26 per cent. on the cost price.

Further examination will reveal under what classification and in what proportion the total investment now stands and the degree of protection it gives to the capital.

Ordinary shares	Industrials	37%	
	Electricity	10%	
	Engineering and Steel	28%	
	Miscellaneous ..	6%	81%
Preference shares			19%
Government loans and debentures			..
			100%

Out of the total capital the highly disproportionate amount of 81 per cent. stands in ordinary shares, 37 per cent. being in Industrials; in Electricity, 10 per cent.; in Engineering and Steel, 28 per cent.; and in Miscellaneous, 6 per cent.

Again, 24 per cent. was placed in Jute shares and it is not known why recommendation of these shares was made in the year 1938 when the industry was in a terrible confusion with

funds considerably dissipated by annual drawings to satisfy ordinary shareholders. These two companies were, no doubt, sound, but why one-quarter of the total funds was recommended to be invested while the industry was passing through very critical times is not understandable, particularly in view of the fact that the prices paid are not very attractive and we cannot imagine what would have happened to these holdings if war demand had not come to the rescue of the Jute Mill industry. Despite the high yield now obtained, it would be advisable to liquidate a portion of these holdings with a view to reinvesting in other shares for the purpose of distribution of risk.

The Andhra Valley Power share is good for obvious reasons, even despite the low yield, and should be retained.

The Indian Iron & Steel ordinary shares, on account of excessive optimism, had once flared up to Rs. 80 and, therefore, this investor might have thought Rs. 60 was a very reasonable price and seeing that they had heavily depreciated after investment, picked up another 25 shares for the purpose of averaging. However, this scrip has let him down badly, but the price of Rs. 32 which is good for these shares under present conditions, yields 7 per cent. They should be retained.

The ordinary shares of Alcock, Ashdown & Co., have appreciated considerably now yielding 3 per cent. only. They appear to be overvalued and should, therefore, be disposed of and the profit booked.

The preference shares of Equitable Coal and Burn & Co. which are very well covered by earnings, may be retained if the investor is satisfied with the yield or if equally good preference shares are not available to yield more.

The Indian Copper Corporation has not been able to show better results despite the fact that its mines and works are being worked very economically. Apparently, they have not been able to strike good ore and in view of the doubtful nature of the shares, they had better be liquidated.

Ahmedabad Advance shares, it would appear, were not bought at a good price and in view of the fact that they are very low yielding—in other words, that the present price is high—they should also be liquidated.

Spence's Hotel shares are hopelessly disappointing. This small company has never fared very well and it would be advisable, therefore, to strike this holding off the list as early as possible.

To summarize, the following shares can safely be eliminated from the list of holdings :—

Alcock, Ashdown,
Indian Copper,
Ahmedabad Advance,
Spence's Hotel,
A portion of Jutes—say all Anglo Indias.

This will mean liquidating ordinary holdings to the tune of about Rs. 7,800, which could be reinvested.

The suggestion of the sale of Indian Copper and Spence's Hotel shares was not welcome to this investor because he feels that by doing so he will incur a loss. This is not surprising, because the psychological view taken by every innocent investor without exception is such. Still more curious, he does not think so about Indian Iron shares that have also depreciated considerably, because like many others he thinks that just because these shares had touched Rs. 80 in 1938 they must see this price sooner or later. He also feels that as long as he is holding them, there is no loss.

This wrong and most misleading impression which is responsible for many of our losses must first be cleared. The price paid to a share has no relation whatsoever with the price ruling to-day. To-day's price is quoted entirely on

the merit of the share unless the market is influenced by powerful outside factors such as the war. Hence the investor can under no circumstances expect to get his capital back intact if the company in which it is placed has a gloomy future. In such cases, the difference between the price paid and that ruling to-day, if it is below purchase price, is a loss whether we continue holding the scrip or liquidate it. If the loss is already there and there is no hope of a substantial recovery, what is the use of hesitating to sell? Such hesitation has burnt many an investor's fingers. They wait and wait even if there is no hope of recovery because they cannot bear to suffer a timely loss, and even if they are induced to sell, they place orders with their brokers at higher limits at which business is never done until the shares have dropped very heavily culminating in a heavy loss. Not less than 90 per cent. of the ordinary investors operating on the Stock Exchange have learnt this lesson at a severely heavy cost.

Instead of worrying oneself over a doubtful and bad share, is it not advisable to sell it outright even if it holds the chance of recovering some day? If it holds the chance then it may or may not give the capital back intact. But if we sell now at whatever price the share is quoted and reinvest the sale proceeds in a sound company having future prospects, we can be

reasonably sure not only of capital appreciation but regular income also which would not be forthcoming from a bad scrip. As there are diseases which require a timely application of scissors, there are bad investments which require a timely sale though at a loss.

To sum up, if the bad share at all recovers, it will be after a long time, for shares in such a state take a long time to recover, but one cannot be sure and in the meantime one keeps on losing dividends. On the other hand, conversion into a sound scrip overcomes the risk involved in a bad scrip and gives that portion of funds an equal, if not a better opportunity of capital appreciation. That this is a sound proposition can be seen from the fact that we are converting the value of a bad holding into a good one without paying anything more.

CHAPTER XVI

Doubtful Shares

Not infrequently, investments, despite the investment portfolio being well constructed, behave indifferently, but one thing is certain: all holdings cannot behave in the same way unless the markets are terribly influenced by politics such as we are experiencing now, and even then a good planning which will include short and medium dated loans and debentures will give good protection to the investor in times such as these.

These are extreme eventualities, however, which we seldom see, and we cannot discuss this point unless we know the circumstances, which always differ, affecting investors. We will, therefore, keep these extremes alone and leave the investor to follow those investors who have made full study of the situation.

Some of the shares, particularly ordinary, which may have been carefully selected for inclusion in the investment portfolio do very often depreciate. Investors who have a variety of holdings will have seen this in their own case. When the values of some of the shares fall and if it is found that on the whole the investor's capital has not been depreciated (due

to appreciation in some other direction), many investors content themselves with the results their investments yield, basing their hope on the anticipation of the depreciated shares ultimately recovering.

This may be all right in a case where shares have been temporarily affected by something or other, and under such circumstances the investor would be excused for ignoring the temporary depreciations. But it would be folly to disregard the depreciation if it is due to fundamental reasons such as stagnation of trade in a particular industry or to some other direct cause affecting the workings of the company in which the investor has interest. For an investor under such circumstances, there can never be a better time than this to take a decisive action immediately and have the investment portfolio cleared of such doubtful holdings.

How to test a doubtful share is difficult to say,—but not very—because there are different factors affecting different shares at different times.

For example if an industry is facing severe competition from abroad not only in India but also in the foreign markets where the industry's production is being sold and if there is no state protection such as increase of customs duty or subsidy, then this would be a sure sign of trouble

for the industry, which would ultimately reflect on shares.

Those companies that enjoy State aid, that have geographical advantage and in some cases those that are outside the sales organization do more business than other companies in the same industry. For example, we may again take the Sugar industry.

This industry has witnessed a strikingly rapid development since 1932—the year of the grant of tariff protection. Since then the number of factories in India has increased from 32 to over 145. The fixation of the highly fluctuating prices of cane by the two governments of U.P. and Bihar in the interests of the cultivators and the uneconomic development of sugar units, have led to considerable difficulty in the industry in these two provinces which has encouraged building of sugar manufacturing units in Indian States and in other places situated far from the main industry, despite the fact that the production of sugar outstripped consumption in India during the time the new companies came into existence.

Out of the total sugar companies about 75 per cent. are in U.P. and Bihar and the other 25 per cent. elsewhere in India. While the factories in the two abovementioned provinces have to work under strict control and inter-

ference of the respective governments, others are free to operate as they like. Therefore, the results are obvious. Almost all the companies in the U.P. and Bihar have begun suffering, particularly those that have been floated since the year 1931. On the other hand, those that are outside these provinces have shown convincing changes in their earnings from year to year. To mention one—the largest and the most important outside unit—the Mysore Sugar Co., Ltd., formed in the year 1933, has with State support shown striking results right from the very first year of operation. The issued capital is Rs. 21,79,280, all in ordinary shares. There is also a debenture capital. The 7 per cent. debenture has almost been paid off and Rs. 8,00,000 in 4 per cent. debenture is now outstanding. Against this total capital of about Rs. 30 lakhs, reserves amount to over Rs. 50 lakhs, all built up within the short period of eight years.

The sudden deviation from the main thread to the Sugar industry might have confused the reader, but the purpose behind it is to show in a way, how a doubtful share can be found out. Those who had invested in the new sugar companies working in the U.P. or in Bihar with the hope of sharing in their prosperity will find these holdings depreciated, and they would do better, under such circumstances, to switch

off their entire weak sugar holdings and invest in the Mysore Sugar Company or in any other outside company that has done well in the past. A buyer of Mysore Sugar shares may have to pay comparatively more, or conversely, the yield may be less, but the fact that reserves within a short period have assumed huge dimensions should warrant a safe holding with the possibility of capital or cash bonus being paid, as is usually the procedure of companies in such a position. From this it should not be inferred that all sugar producing companies in the U.P. and Bihar are unsuitable and all the rest are eminently suitable for investment. Holdings in sound companies of long standing, of which there are many, are certainly worth retaining or buying.

We have said about an industry as a whole, but in the case of miscellaneous companies the foregoing procedure will not help. It may be that a company in which 10 per cent. of the capital is invested, is superseded by another one doing the same business and that the former company is unable to stand the competition of the latter. In this case it would be advisable not to hesitate any longer but to liquidate the holdings even at a loss and reinvest the sale proceeds in its competitor or in a better company which promises to fulfil the investors' object. In this way we shall be avoiding further depreciation usually

caused by reluctance to sell, hesitation and tardy action on the part of the investor.

Again, it may be that a whole industry is fundamentally affected, depreciating all the holdings of the investor in it. Under these circumstances it would be unwise to liquidate all weak holdings and reinvest the sale proceeds in sound companies in the same industry as is very often done. It is obvious that when an industry as a whole is on bad days, all weak and strong shares must suffer alike, and therefore conversion does not materially help the investor, unless shares of a sound company, taking primary factors into consideration, are available much below their intrinsic value.

These are but a few of the hundreds of causes that affect shares and securities, and the investors who keep in close touch with their holdings by reading carefully the Chairman's speech which in almost all cases gives a glimpse into the future of the company's trade, and the balance sheets issued in connection with their holdings will be able to judge fairly well which way the wind is blowing.

CHAPTER XVII

Conclusion

In the foregoing chapters we have attempted to present to the reader, step by step, and in a practical way, a scientific system in which an investor can compile an investment portfolio suitable to his own requirements and manage it advantageously without the help of others. It is felt advisable to repeat here some of the points we have already discussed before. They are by no means all the important ones but are given in the hope that they will guide the investor towards the right beginning of a difficult investment task which, hitherto, has not received due attention from the Indian investor.

Ordinary Shares.

The most interesting amongst all the classes of shares are ordinary shares. They are mostly responsible for the success or the failure of investors. As most interest is displayed in these shares one or two words before passing might be helpful to the investor. The shares of well-known Banks, Electricity and Insurance companies do not require as much investigation before buying as is necessary for industrial, engineering and other shares, all that is necessary being to wait for an opportunity and to invest after comparing the yield of the proposed share with that given by other shares of its class.

This cannot be done, however, with other ordinary shares. To test them, the following points should be considered :

(1) Whether the company is strong financially and with ample reserves viewed in the light of hints given in the chapters on Balance Sheets, and roughly to what extent it was affected by the last depression.

(2) Whether the earnings have been steady in the immediate past, giving particular attention to the policy of the directors in the distribution of profits. If the profits are distributed up to the hilt then it must be inferred that the directors are not conservative, and the investor who buys during the year a large profit was made will lose a portion of his capital if emergency compels him to sell during the year in which the company's profits have suffered, because lower dividends will naturally be declared resulting in a fall in the prices of shares. The policy of prudent directors is to conserve as far as possible all, what in their opinion are, surplus profits and equalizing dividends during the periods the profits suffer, thus stabilising indirectly the prices of ordinary shares.

(3) Whether the yield compares favourably with that given by the ruling prices of the shares of the same class. To purchase shares of larger yield because other income is insufficient is always a mistake. We must bear in mind the dictum that, normally, "the greater the yield, the greater the risk." Not to say that good shares do not give a high yield. In times of crisis first class ordinary shares fall considerably irrespective of their intrinsic value. It is at this time that they should be bought without the loss of any time in hesitation, for they do not remain available long.

(4) Whether there are good prospects for the industry in which the company concerned is engaged.

A comparison of the present price with the lowest and highest prices of the previous year or years is not always helpful. It will help only if the dividend is well maintained. Otherwise, what use can the lowest and highest prices be if the last dividend paid is less than that of the preceding years when the company was making satisfactory profits?

It is inadvisable, either, to compare the face value of an ordinary share with its market value. One of the things investors are commonly reluctant to do is to pay a high premium (amount above the par value). The Kumardhubi Engineering ordinary shares, on account of several unsuccessful years, are quoted 50 per cent. below their par value but the Tata Iron & Steel ordinary shares are quoted over 400 per cent. above their par value. Still, the Kumardhubi shares are bad and the Tatas good for obvious reasons. Ignore the face value while considering the purchase of an ordinary share unless it is partly paid, in which event the buyer will be carrying liability to the extent of the uncalled amount.

New Flotations.

Investment in new flotations should, as far as possible, be avoided, particularly in

ordinary shares. This bit of advice is certain to meet with a lot of criticism from patriotic Indians who are conscious of the fact that the well-being of a nation rests on its industries. We read of hundreds of prospectuses of new companies advertised every year in the press. A close examination of these shows that most of them are lacking in something or other so that they do not at all appeal to the public. More often than not their capital is so very small that the public is backward to venture its funds in such undertakings, (1) on account of the inattractiveness of the board of directors; (2) for fear of the issue being under subscribed; (3) even when the issue is fully subscribed, for fear of its coming into difficulties owing to want of further funds; or (4) on account of inadequacy to face competition, which results in the concern very soon falling into the hands of liquidators. We know of a score of recent flotations in this state. It is better to ignore such companies than to risk one's capital with no high hopes of a decent reward.

A case the writer had the occasion to handle very recently was of a person who had invested roughly Rs. 20,000 in companies floated between 1919 and 1922. Most of them are finished and forgotten, and the frozen holdings of this unfortunate investor are now valued at slightly

over Rs. 1,000 for which there does not appear to be any buyer. What we really ought to come forward to support by every means available, is huge undertakings sponsored by businessmen of integrity who thoroughly investigate the scope of their business before embarking upon a new venture. Such concerns must be helped even at the risk of a portion of our capital, for they hold the possibility of revolutionizing the poor conditions of the units of our basic industries. Two such recent undertakings are the Steel Corporation of Bengal Ltd. and the Tata Chemicals Ltd. These concerns were well supported by the public and it is almost certain that they are going to raise the standard of the Indian industry as a whole. We have to stimulate the Indian industries by whole-hearted support to the right ventures only; not to the petty ones which almost always result in failure, thereby injuring our already shy capital.

Distribution of Risk.

Of equal importance with finding a good share suitable for individual requirements is the distribution of risk. One of the lessons the Investment Trust and Insurance companies teach us is the scientific averaging of risks. Risk is attached to all types of investments. To some more than others but the investor who

puts all his money in one company or divides it among several companies of the same group or industry is running a greater risk than another who prudently spreads his capital over a variety of shares. It would seem impossible to do just what Investment Trust and Insurance companies do with huge resources at their disposal. It is possible with individuals with a reasonably large capital to follow the investment method of such companies, but with others it will at least be possible, by distribution to the extent the funds permit, to ward off the greater risks that beset the path of an indiscriminate investor. Just for the sake of distribution of risk, a little of capital in one class of shares and a large amount in another defeats the purpose of the investor. Variation of distribution in a moderate form is only advisable where investment is made in accordance with the planning suggested in Chapter XIV ; otherwise, where funds are ample, equal distribution would result in greater advantage in the long run.

When to Buy.

It is inadvisable to hasten to invest money soon after it comes into our hands. We lose hardly anything by waiting a few weeks or even a few months for a suitable opportunity. All that we may lose is the dividend on the share we have been contemplating to buy, but it will

be admitted by every investor that it is better to forego a dividend sometimes while waiting for a set-back in the market than to invest on the firm market, for it will amply compensate us for the dividend we may have lost. Our first consideration should be safety of capital and security of income. If we keep this object in view our investment business will rarely disappoint us. Too much in high yielding and speculative shares will some day hit us and hit us hard, unless we are always on the look-out. Every investor who has neither the time nor the patience to keep a constant watch over happenings that affect the market, should confine himself to good class shares, placing as little as possible in speculative counters just to satisfy his desire, should he have any.

It must not be inferred from this that it is always advisable to buy anything on the depressed market if an investor thinks that the drop in a particular share is remarkable. One instance of the so-called wisdom with which innocent investors go to buy a share is that it is quoted much below the rate it was standing a few weeks or months back. They simply compare past and present prices of a particular share and if satisfied with the difference, buy without investigating the cause of the fall. The fall may have been due to such a cause as anticipation of a lower dividend on account of decline in business,

in which case it will be almost impossible for the shares to fulfil the investor's requirements, unless the anticipation is falsified by the maintenance of the dividend. It would be folly to buy just because the share has dropped or others are rushing to buy it, without satisfying oneself that the share or security which one is going to buy is good. If after investigation it is found that the fall is unjustified, then by all means buy.

CUTTING A LOSS.

The weakest point of the investor is cutting a loss. As we know and have already said, cent. per cent. of our holdings do not always and not even generally come up to our expectations, whatever way investments may have been made. Some must fail. When we are faced with such a situation and if disappointing holdings do not hold any hope of recovery, then it is no use continuing to possess them. To sell at this juncture signifies to almost all investors a loss. But you do not incur loss by selling. Loss is already there and it is by selling now that you avoid further depreciation of your particular holding. Even if the bad holding has a little hope of recovery, it will be ten times better to liquidate such a holding entirely and reinvest the sale proceeds in a sound company having future prospects. This

will not only prevent further loss and keep you free from anxieties but also make your investment portfolio stronger with an equal, if not a better, chance for the recovery of your lost capital. This is the only safe way to manage an investment portfolio successfully when some of the holdings prove to be doubtful. But if the depreciated holdings have a good chance of recovery then it should make the investor increase them for the purpose of averaging, even at the cost of realizing a portion of other shares and securities if he has no ready funds available.

When to Sell.

Another perceptible reluctance in almost every investor is to take small profits. In our days when markets are entirely influenced by politics, good and bad holdings alike rise or fall independently of their intrinsic value, offering ample opportunities for a shrewd and cautious investor. To operate in this way does not necessarily mean speculation as some might like to call it. If we come across an unexpected opportunity solely due to speculative reasons there is no reason why we should not book the profits and anxiously wait for a fall which we know ought to come. This brings to mind two such cases. One investor had Alcocks purchased at Rs. 500 each and another also had

Alcocks bought around the same price. The former investor anticipating a rise of Rs. 100 had given instructions to his broker to sell at Rs. 600, whereas the other by selling at every rise of about Rs. 50 and re-buying at every fall had made a profit on each share of Rs. 250 within the time (two years) the former investor had the occasion to sell at his estimated rise of Rs. 100 per share. No doubt, both profited, but one 2½ times as much as the other. As we said, buying at low prices and selling at high, within reasonable and permissible limits does not amount to speculation. In fact, this is the only way in which cautious investors can make some money in times such as these. It is, of course, understood that such a procedure is recommended to those who have enough time to devote to their investment business otherwise it would be inadvisable to manipulate in this way.

To know when to sell in normal times, reverse the principles we recommend for buying. If the share has risen so as to yield less, if there are no bright future prospects for the industry, if the outlook is gloomy, if the earnings have not been well over the last dividend requirements, then sell. Good Electricity, Bank and Insurance companies' shares generally yield less on account of permanent investment demand. Their earnings being subject to a steady rise and

there being a consequent possibility of increase in distribution, they are locked up. Therefore, these shares should be viewed differently.

BROKERS.

As brokers themselves admit, there are good brokers and bad. On account of the existence of the latter type of brokers too much attention is sometimes given by some investors to the checking of the prices at which business was struck. It is a waste of time and energy. We cannot check brokers. Pay them their brokerage and get clean business out of them. It pays in the long run not to object to the higher rate of brokerage. After all that is their business, and the curtailment of their main source of income would indirectly affect the investor. The best way is to look for brokers of repute. There are Stocks and Shares, Bullion and Exchange Brokers who are not immune from risks forced upon them by their constituents. A few years ago when two big Bullion speculators failed involving lakhs of rupees, one of the brokers had to make good his constituents' loss to the tune of rupees three lakhs. The reason that led him to shoulder this huge amount for others' sins was naturally to maintain his reputation as a broker. Such are the brokers investors should look for. Do not 'bargain.' Give them their dues. You will not repent.

TIPS AND TAPS.

Beware of tips. Tips are taps. Tips such as those circulated in loud whispers in the market are taps for the manipulators whose victims are the innocent public. Close inquiry into the affairs of most of the investors tells us that their investments are based on advice and tips received from their brokers or friends.

Remember, tips are not for investors; they are for gamblers. Tips have the essence of secrecy. Ask yourself whenever you had had a tip in the past what its nature was. "Such and such a share is being manipulated and it will very shortly rise"—that may be your tip and the share may have risen. But had that tip anything to do with the substantial working of the company? Tips are for gamblers, just in the same way as punters get so many free and cheap tips on the race-course. If you are an investor, you should not concern yourself with such misguiding tips. Let others around you profit by tips and let them be millionaires. Indulge cautiously in your investment business and you will soon discover that you were the wisest of all your gambler friends.

Brokers and friends can help us very little in the matter of investments unless they get inside knowledge of the company through their

association with the directors or managers. It is only then that such genuine information can help us; but even then by the time the information reaches us the particular share will have already been operated upon by others getting the same information. It is not the business of the broker to make recommendations. His business is only to act as an intermediary. But some brokers specialise in investment service and it is only from these brokers that advice should be sought or accepted.

KEEPING ACCOUNTS.

How many of us, we wonder, keep details or accounts of our investment business? Not even 1 per cent. perhaps. If we were to utilize the same funds in business, need we say that we would be keeping all sorts of accounts, stock books and what not? All we do after buying our shares and securities is to tuck them away or if they are many, to pass them on to the Banks for safe custody so that they may not bother us any more.

We cannot know whether our investment business is a success or a failure unless we know what they produce and in order to know this we naturally ought to have a booklet where all the necessary details are entered. Where transactions are many, they may be entered as follows :—

A/c. of *Ord.* Shares of .... *Tata Iron & Steel* .... Co., Ltd.

Date.	Bot.	Sold.	Bot. or Sold.		Balance.		Average Price.	Remarks.
			Rate each.	Total.	No. of shares.	Amount.		
			Rs.	Rs. a. p.		Rs. a. p.	Rs. a.	
1941								
Jan., 3 ..	10	..	250	2,500 0 0	10	2,500 0 0	250 0	
March, 30 ..	..	5	300	1,500 0 0	5	1,000 0 0	200 0	
June, 7 ..	5	..	260	1,300 0 0	10	2,300 0 0	230 0	
July, 15 ..	5	..	240	1,200 0 0	15	3,500 0 0	233 5	
Aug., 20 ..	..	5	225	1,125 0 0	10	2,375 0 0	237 8	
Nov., 21 ..	..	5	250	1,250 0 0	5	1,125 0 0	225 0	

This is one of the most simple and practicable methods of keeping accounts, its object being to keep a record of investments in such a way as to be able to know at a glance what exactly the position of an investor is in regard to his particular holding. The column provided for average prices is the most important. After working out the average on every purchase and sale, an investor is put in a position to see to what extent, on the whole, he is making a profit or a loss.

Thus, after keeping the profit and loss on sales in the business the statement shows that on November 21, 1941, the balance of 5 shares stood at the low average of Rs. 225 each and if, say, on December 17 the market value of the shares was Rs. 275 we could immediately know that the difference of Rs. 50 per share would be our ultimate profit if we sold the shares that day.

At the close of every year (at the option of the investor, it may be 31st December, 31st March, Samvat, Misri or Parsi New Year) such balances may be transferred to a statement prepared on the same basis as previously illustrated on page 187. From such a statement the investor will be able to say at a glance where he exactly stands and whether there is any need for eliminating some of the holdings or

actually increasing them. It is only after making a proper survey of our investments that we can form a definite opinion and decide confidently what steps should be taken to consolidate the list, if necessary.

INVESTMENT PLANNING.

Some of those who already have a knowledge of this subject may like to argue some of the points raised about the mode of scientific investment. One of the points where they will not fully agree may be where we emphasized the importance of an investment policy before embarking upon the task of investments, because they will have successfully transacted their investment business before, without any sort of policy whatsoever. These are exceptions. The author is fully conscious of the fact. So also of the fact that hundreds of investors made their capital suffer just for want of a definite investment policy. Only investment consultants will know how far this is true. The writer throughout his short experience has come across hundreds of cases where investors have made money and have also lost money owing to lack of planning. More than 99 per cent. of the cases handled were without any planning. Nevertheless, most of the investors were persons guided by others who hardly had any special knowledge of investments, their recommendations

being of some of the popular scrips on the market dinned into the ears of everybody who frequents the Stock Exchange floor. We do not mean to convey to the reader that cent. per cent. of the investors who manage their investment business according to the recommended planning will be successful. Not even an insurance policy can be cent. per cent. safe. But it is definite and an admitted fact that the art of investing as suggested will, on the whole, yield more advantages than those that have hitherto been enjoyed by a haphazard or an indiscriminate investor owing to the Indian markets on the whole having been one-sided for the last few years. Practically everybody who had invested a few years back had the fortune of seeing their capital appreciated considerably because the trend, on account of the immense possibilities for expansion of the Indian industries, was on the up-grade. The real test of investments comes when the markets are two-sided, and it is here that the unmethodical investors stand to break their backs. If the mighty Investment Trusts and Insurance Companies all over the world have found the method of spreading risks in a scientific way advantageous, we see no reason why it should disappoint us.

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